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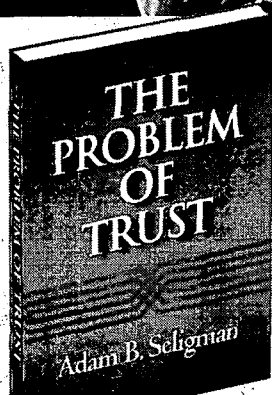
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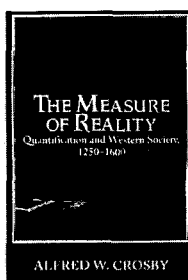
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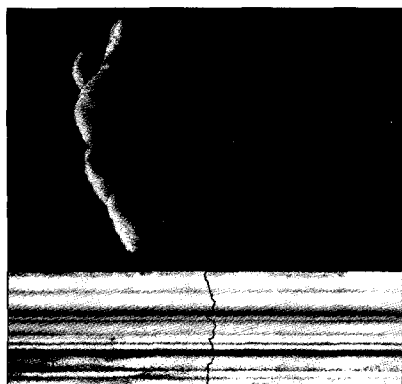
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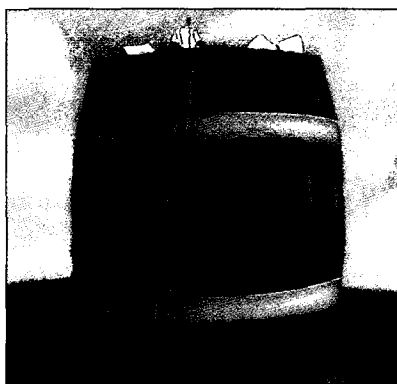
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WINTER 1998 VOL. 16 NO. 1

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ADVERTISING

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Renuka Deonarain, Garry Sparks,

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www.brook.edu***A CONSIDERED OPINION**

The Battle Over I

In a dozen B-movies from the 1950s, cowboys formed a posse, saddled up, and rode around shooting into the air. There was always a lot of noise and bad dialogue, but little real action.

The battle over reforming the Internal Revenue Service has much the same character. There is no doubt that the IRS is a troubled agency that badly needs fixing, but there is serious doubt that the reform bill Congress is considering will do much to solve the problem—and a good chance it will make things worse.

The movement to fix the IRS got huge boosts from a June congressional commission report and September congressional hearings featuring testimony by wronged taxpayers and by IRS agents, veiled behind confessional screens, who admitted taxpayer abuses. The House Republican leadership seized on the hearings and the public's eternal distrust of tax collectors to embarrass the Clinton administration into big concessions. In November, with only four dissenting votes, the House passed a major IRS reform bill.

The bill contains many solid proposals, but two issues are troublesome: creating a new board, dominated by individuals from the private sector, to make key decisions about IRS governance; and putting the burden of proof on the government in tax-court cases. There is little evidence that these changes would cure the IRS's problems—

and strong evidence that they could deepen the agency's predicament.



Donald F. Kettl is director of Brookings's Center for Public Management and director of the Robert M. La Follette Institute of Public Affairs at the University of Wisconsin-Madison. He is the co-author of Civil Service Reform (Brookings, 1996) and Improving Government Performance: An Owner's Manual (Brookings, 1993).

To attack the IRS's governance problems, the House voted to create a new 11-member board that includes the secretary of the Treasury, the IRS commissioner, a representative of Treasury Department employees, and eight representatives from the private sector. The IRS reform commission had concluded that top Treasury officials had failed to provide effective leadership to correct mounting IRS problems and that private-sector ideas and a corporate-style board could provide a firmer hand and better ideas.

The new board, however, poses three big problems. First, it would create serious and unavoidable conflicts of interest. The problem is not so much having experienced private-sector officials set the IRS's course. It is having them serve on the board part-time—probably only a day a month. Sooner or later—probably sooner—every private-sector member would face a vote that would affect the operations of the business or organization from which he or she came. Such conflicts of interest are unavoidable. Even monks and nuns would have to recuse themselves from decisions shaping IRS policy on auditing nonprofit charitable organizations.

Fixing the IRS

No private-sector company would fill its board with competitors or others who might have conflicts of interest in setting corporate policy.

Second, no private-sector company would focus so strongly on structuring its board without also rethinking its operations, from top to bottom. Tales of failed corporate shakeups, triggered by changes concentrated at the top, litter the private sector. Nothing in the IRS will change until senior managers find a way to grab the agency by its bureaucratic lapels and shake reform into it. The private-sector board is an unlikely tool to accomplish this.

Third, the bill gives the board considerable power over IRS operations. The board would have broad authority to approve the IRS strategic plan and the agency's budget. But there are serious problems in putting such governmental powers into the hands of a board dominated by private-sector officials. And there is also the likelihood of serious confusion over managerial responsibility and democratic accountability. While the board would approve the IRS budget, the Treasury secretary would retain the power to submit the budget to the Office of Management and Budget. The board, meanwhile, would have the power to approve the IRS strategic plan (including decisions like how to target audits and what balance to set between compliance enforcement and taxpayer assistance). The likely result of such divided responsibilities is confusion—what to do and how to pay for it—that could well further undermine the public's already shaky confidence in the IRS.

The proposal to reverse the burden of proof, likewise, creates serious problems. The argument for the shift is this: why assume defendants are innocent until proven guilty in most courts, but assume taxpayers are guilty until they prove themselves innocent before the IRS? In fact, the bill would reverse the burden of proof only in tax court and only on questions of fact (not of law). Taxpayers would still be responsible for demonstrating good-faith compliance in all the steps leading up to trial.

Despite the bold rhetoric, the proposal would probably affect only a few thousand taxpayers a year. Unscrupulous taxpayers might be tempted to destroy records—the IRS could not prove guilt without finding the evidence. The IRS in

response would have to be even more aggressive in audits to ensure it collected evidence it needed to win in court, even as it tried to be warmer and fuzzier in dealing with taxpayers.

Both the bill's flagship reforms, therefore, are much less than they seem, yet they create the potential for great mischief—precisely what the IRS needs least. The agency does have huge problems to solve: a customer-service effort that too often leaves taxpayers unsatisfied; an enforcement program that too often has trampled on taxpayers' rights; and an information system that, even after a \$4 billion investment, does not equip the agency for the job it must do.

What would a genuine reform look like? First, inconsistent political leadership has crippled the IRS. The IRS will never change until top Treasury officials make reform a top priority and until Congress provides the necessary support. In recent years both Treasury Secretary Robert Rubin and Congress have put strong efforts behind reform. The key from here lies in a continued steady hand.

Second, the IRS needs strong management. The appointment of information management expert Charles O. Rossotti to head the agency is a good start, but the commissioner needs room to work and a mandate for action. The commissioner should be hired on a five-year contract that holds him or her accountable for performance and provides rewards for work well done. The performance goals, in turn, ought to guide agency operations from top to bottom. That strategy drove reform of New Zealand's tax agency and could vastly improve the IRS.

Third, IRS managers need far more flexibility: managerial, budgetary, personnel, and procurement. Up against the world's smartest tax experts, they need the ability to stay even by building the best systems, hiring the best people, training them effectively, and motivating them to perform.

Fourth, the IRS badly needs the insights of both citizens and smart private-sector managers.

There ought to be a board to provide such counsel—but it ought not to be placed in the chain of command. That could only disrupt the accountability of public officials for public programs.

On one level, of course, no change can ever truly "reform" the IRS. Since revolutionaries tossed English tea into Boston Harbor, Americans have never liked tax collectors. Trying to extract payments that taxpayers really don't want to make will never be easy or pleasant, no matter how strong the IRS's commitment to friendly, solid advice. But shooting guns into the air is not the answer. The troubled IRS needs solid reforms that solve the real problems. ■

There is no doubt that the IRS badly needs fixing, but there is serious doubt that the reform bill Congress is considering will do much to solve the problem.

“Regulatory reform.” For most Americans the first reaction to these words may well be a yawn. Even inside the Beltway, only the most tireless stakeholders and policy wonks can get themselves worked up over the arcana of rule-making procedures, benefit-cost calculations, risk assessments, peer evaluations, and legislative oversight.

But the conduct and course of American regulatory activities warrant serious and sustained public attention. Regulation, after all, touches the lives of all Americans every day, and its reach keeps widening. In the 1990s, a fiscally constrained federal government has shifted more and more of the nation’s social agenda into off-budget mandates. Each year the cost of those unfunded directives far exceeds the total of U.S. personal income taxes collected. If it is fitting and proper to question the quality of the public goods and services this society buys with its tax collections, it is surely no less important to debate vigorously the balance of social gains and losses from the government’s other exactions, including those imposed by its voluminous rules and regulations.



Lifting the Heavy Hand

Such a debate can lead in multiple directions. First is the matter of accountability. How can institutions be arranged to compel regulators to answer for wasteful decisions but also to reward policymakers when they pursue the best means to cherished ends? All institutional arrangements—including the devolution of regulatory programs to lower levels of government, the privatization of programs, or their outright abolition—entail at least some unintended consequences. The second question then becomes whether any given rearrangement risks creating more problems than it solves. The instability of the status quo but also of some supposed remedies can increase as new technologies come on stream. In a global economy, moreover, national regulatory systems face a host of other novel responsibilities. Increasingly, rules with only a domestic intent reach across borders. Sometimes they may pose undue burdens for trading partners and foreign investors. Under what circumstances should nations adjust or “harmonize” their preferred practices? And when change is imperative, why are some countries more nimble than others?

In the first of our nine articles on the challenges confronting the regulatory state, I explain the growth of U.S. regulatory intervention over the past decade and offer some thoughts on how the increasingly troublesome costs of this trend might be lowered through a more judicious application of checks and balances.

Christopher H. Foreman reports on the limited, but not insignificant, accomplishments of the 104th Congress. He notes that some of the foundation is now in place for a process of systematic regulatory review capable of curbing the use of senseless “zero tolerance, zero risk” standards to safeguard public health and safety. But he also stresses that building on that foundation will be, at best, a slow, incremental process.

Although 1997 was not a year in which a lot of regulatory issues excited passions, at least one certainly did. Litigants, public and private, launched an all-out assault on cigarettes. W. Kip Viscusi takes a closer look at this reprise of prohibitionism. He finds that some of its rationale, including the central claim that smokers constitute a massive financial liability for state governments, is suspect. A sound policy on smoking, Viscusi concludes, would depart from the proposed legal settlement now pending in Congress.

Another question of regulation that Congress could not duck this past year concerned political campaign donations. Thomas E. Mann casts a skeptical eye on recent proposals to “deregulate and disclose” campaign finance, observing that full disclosure is easier said than done and even if done, offers no assurance that voters will make use of it to punish abuses. Deregulation here might prove as ineffectual at correcting

REGULATION

excesses as is today’s complex system of rules and rulings.

Whether, or how much, environmental programs should be devolved from federal to state hands has also remained a subject of considerable interest. Mary Graham writes that contrary to conventional wisdom, state administration of environmental protection does not typically degenerate to a “race to the bottom.” Instead, she finds the more pertinent concern to be the classic defect of federalism: namely, uneven quality between rich and poor states.

A further complication for regulators presiding over rapidly moving targets such as financial products and services is the pace of technological change. Steven M. H. Wallman shows how rulemaking by traditional command and control is not just impractical in today’s electronic financial markets; it is becoming infeasible.

Regulatory actions of governments can also have broad international implications, as evidenced by the recent heated antitrust dispute between the United States and the European Union over the legitimacy of the Boeing-McDonnell Douglas merger. Eleanor M. Fox shows that this important case, often seen as a politicized effort to protect national “champions,” actually involved fundamental differences over matters of principle, as reflected in the goals of U.S. and EU merger law.

David Vogel delves into two other trade conflicts springing from idiosyncratic U.S. regulations, one pertaining to energy conservation, the other to the clean fuel requirements of the 1990 Clean Air Act. Alternative policies were available to achieve the same U.S. social objectives. Had they been chosen, Vogel shows, the interests of American consumers as well as those of foreign competitors would have been better served.

Last, Edward J. Lincoln and Robert E. Litan step outside the U.S. context and assess Japan’s recent steps toward deregulating financial markets. From the standpoint of comparative politics, the larger lesson in this story is plain enough. The United States continues to experience its share of difficulties shedding the deadweight of too many inefficient laws and lawsuits, but Japan—the world’s second largest economy—remains hobbled by an apparent inability to restructure even its most basic economic institutions, such as its malfunctioning banks.

Perhaps the next best-seller about who is likely to be “Number One” in the 21st century will need to focus not on strategic trade and industrial policies, but on which society has cleared its tangles of legal strictures and regulatory red tape. ■

Pietro S. Nivola is a senior fellow in the Brookings Governmental Studies program.

The Challenge of Reforming America's Regulatory State

As the federal government's discretionary spending in the 1990s has become less lavish, so has the supply of old-fashioned lard in the U.S. budget. But if you think this means the era of big government is over, think again. Another pork barrel is burgeoning. Along with preferential micromanagement of the tax code, the bacon these days takes the form of unfunded mandates and regulatory programs and of public facilitation of private lawsuits.

Figure 1 tells most of the story. Led by robust military budgets during the late 1970s and the 1980s, discretionary spending increased. Until 1988 the estimated costs associated with federal regulatory activities declined in constant dollars as the economy realized tens of billions in savings from deregulation of the transportation and energy industries and from the Reagan administration's concerted efforts to curb costly new regulations. Afterwards, however, regulatory costs turned up sharply and have been on the rise ever since. A profusion of new rules and legal liabilities increasingly bore down on business decisions about products, payrolls, and personnel practices. By the mid-1990s these costs were approaching \$700 billion annually—a sum greater than the entire national output of Canada.

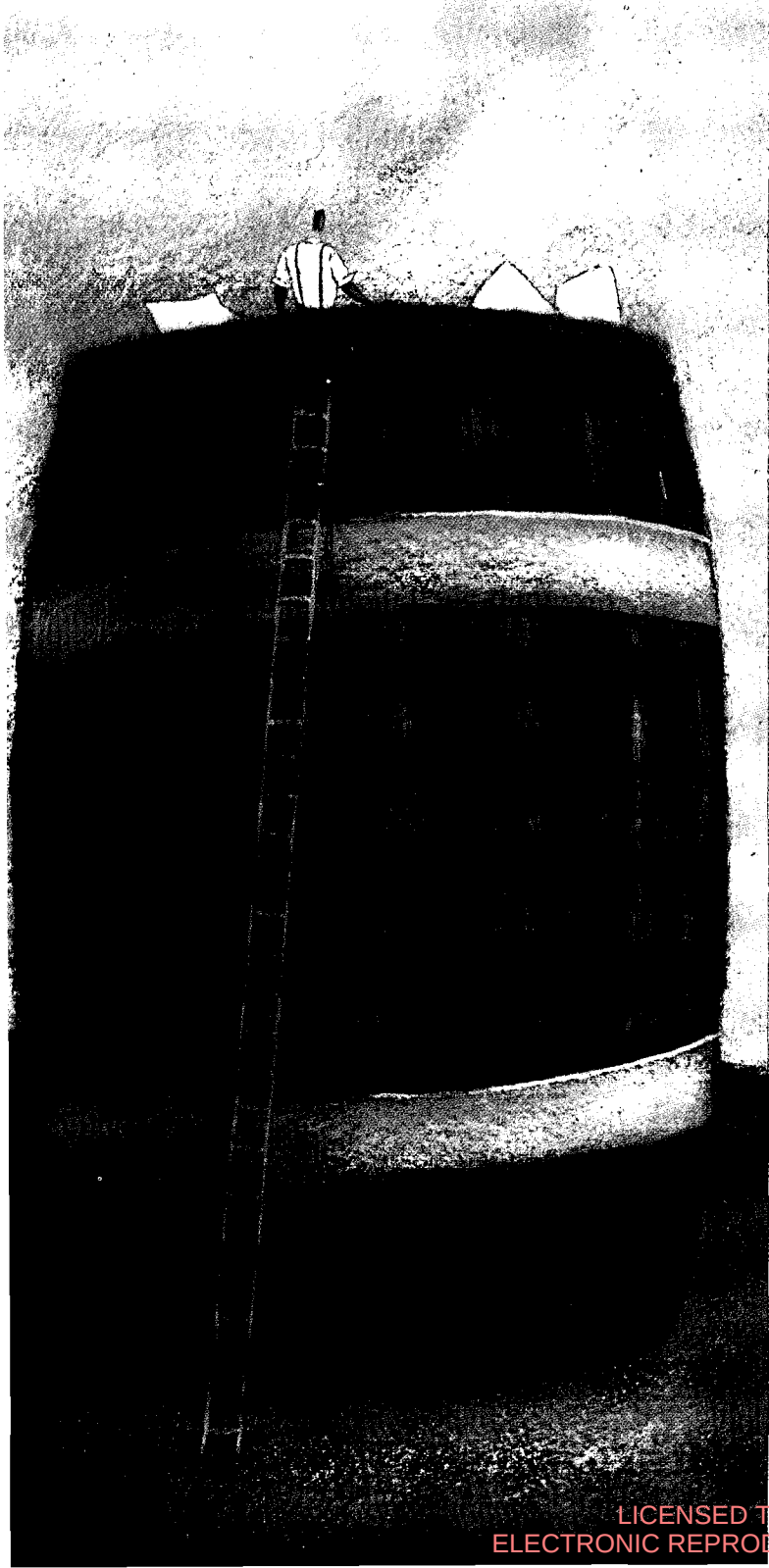
EXPLANATIONS

Whatever else explains this trend, surely it demonstrates that fiscal constraints have not limited the ingenuity of politicians and their clients. Policies that are barely visible on the budget books can still intervene massively on behalf of special interests—and can do so, conveniently, without worsening the deficit or imposing transparent tax increases.

For instance, rules that have encouraged the use of ethanol (a fuel made from corn) are a kind of pork for corn farmers, only less obvious than, say, appropriating millions for irrigation projects in Corn Belt states. Often costing billions of dollars per cancer prevented, the Superfund law to remove carcinogenic toxins from waste dumps is charging society a small fortune. But Superfund's congressional appropriation is suitably modest,

Pork Barrel

and What Reformers Need to Do to Get It Right



and the program is a gravy train for particular groups, like the thousands of lawyers engaged in cleanup litigation. Similarly, antidumping provisions in the trade laws, devised to regulate “unfair” foreign price competition, require small budgetary outlays to administer. At times, however, these regulations force consumers to pay markedly higher prices to protect a handful of domestic companies. The practice of crafting protections and preferences for selected groups in the name of civil rights is a relatively low-budget operation too. But this regulatory regime nonetheless reaches deep into the private sector, dispensing rewards to the regime’s extensive vested interests. There is no shortage of examples of Washington’s off-budget spoils system.

Though the regulatory pork barrel frequently serves well-organized constituencies, its scope tends to be broader than the traditional treats (a new post office here, a new road or sewer there) that members of Congress offered to their districts. In contemporary American politics, this difference is an added advantage for members of Congress who need increasingly to curry favor with *national* lobbies and pressure groups that provide valuable political backing. The pattern of influence and obligations is reflected in congressional campaign finance. Whereas candidates in House elections, for example, used to rely for support almost entirely on local constituents and state parties, now the winners draw almost 40 percent of their contributions from political action committees, that is, from the funding arms of national interest groups. Prosaic projects, reaching only hometown folks, do not satisfy many of these hungry organizations; they expect, instead, a diet rich in ubiquitous social mandates: more safety devices in *all* motor vehicles, pure water in *any* river, equality of athletic programs within virtually *every* university, prohibition of smoking from sea to shining sea, and so on.

The number and cost of such commandments also keep mounting because of the extraordinary legitimacy they are accorded. In part, this situation reflects the skill of their advocates and patrons at marshaling notions of fairness or

Part of this essay is based on a longer article that will appear in the spring issue of The Public Interest. Pietro S. Nivola is a senior fellow in the Brookings Governmental Studies program. His most recent book is an edited volume, Comparative Disadvantages? Social Regulations and the Global Economy (Brookings, 1997).

JOHN BERRY

rights. Thus, the trump card played by champions of rigid antipollution regulations is that all citizens have "an inherent right" to a pristine environment. The mandating of benefits for each new class of disadvantaged people reflexively summons the Fourteenth Amendment, rather than a plainspoken demand for government funding. The clinching argument in many product injury verdicts seems to be that buyers should bear no responsibility for the risks they run since consumers are entitled to be absolutely safe. The time-honored defense of antidumping regulations is that they uphold the economic rights of firms and workers victimized by foreign predators who employ "pauper labor."

Because regulatory pork barreling is presented not as a system of special favors, but as a means of honoring solemn legal claims, the claimants are often given a direct hand in enforcement. Many regulatory activities, in other words, gain momentum because they deputize vigilantes. Most environmental statutes and consumer protection laws invite citizen suits to ensure compliance. Of late, the employment laws have induced a surge of job-bias class actions. Various interests are parties to these lawsuits or become beneficiaries of them. Besides awarding significant sums to nonprofit advocacy groups, settlements have ordered a bevy of purchasing contracts and franchises to designated for-profit organizations and produced a billable hours bonanza for the contingency lawyers and for a cottage industry of diversity management consultants.

CONCERNS

Does all this pose a problem? A prosperous, civilized country should be expected to regulate harmful types of economic fraud and abuse, to reduce socially corrosive inequities, to bar morally repugnant forms of discrimination, and to protect the health and safety of its citizens. Despite the soaring costs of the policies produced by these exertions, their net worth is sometimes impossible to measure. Even though

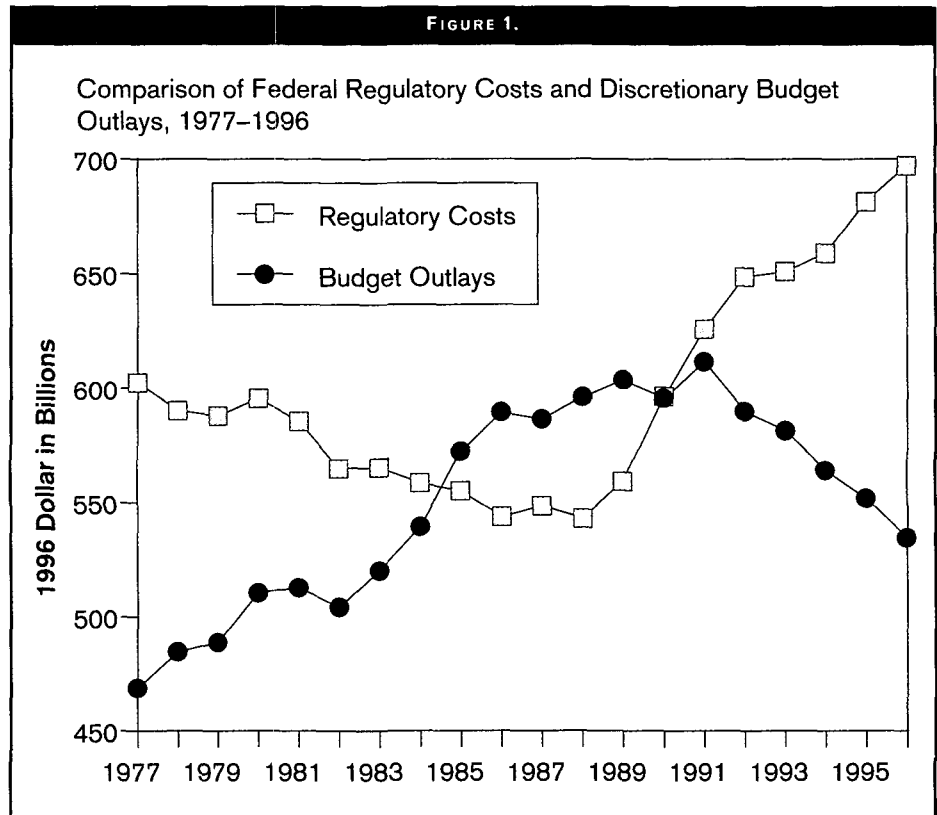
REGULATION

many of them advantage certain groups while disadvantaging others, society may have decided that such uneven outcomes are virtuous and just. And the fact that politicians pull in campaign funds and votes with the decisions does not, in itself, invalidate them. Pork, courtesy of other people's tax payments

implications, which sooner or later would alarm deficit hawks. Wasteful as these expenditures and tax measures frequently are, at least they have borne clearly the signatures of elected officials, who occasionally might be asked to answer for the consequences of their actions.

The new system is murkier. Its contents extend far beyond earmarked

FIGURE 1.



or of regulatory exactions, is a staple of politics. Without it, democratic government would lose some muscle as well as flab.

What is unsettling, however, is the seeming ease or insouciance with which current political arrangements seem to crank out expensive directives that invoke high principle to conduct, in Ambrose Bierce's phrase, "public affairs for private advantage." The old pork barrel, stuffed as it was with federal bricks, mortar, and macadam, at least had to be paid for with tax dollars or with deficit spending. The favoritism was explicit, concrete (often literally), and visibly priced. Even the subtler fiscal delicacy, targeted tax relief, has had reasonably obvious budgetary

appropriations or tax breaks to a stack of selective legal strictures that appear budget-neutral and "tax free," and that are partly in the custody, so to speak, of unaccountable private attorneys general. In contrast to honest spending and tax bills, no consistent effort is made to score the economic impacts of the voluminous mandates, especially those that emanate from the executive branch. Hence, as Robert Hahn and Robert Litan recently reported, approximately half the federal government's social regulations issued between 1982 and mid-1996 generated costs plainly in excess of social benefits, yet remained unchallenged.

The rise of legal and regulatory burdens may seem of trivial consequence

to America's formidable economy, but in fact the productivity and incomes of Americans would have grown more rapidly if the nation's cost-oblivious penchant for regulatory sanctions and suits had been brought under better control. As a conservative estimate, just ridding the *Federal Register* of the manifold rules since 1982 that flagrantly flunked an elementary cost-benefit test would have increased the size of the economic pie by almost \$300 billion. Fixing countless other programs whose net benefits are not being maximized would "grow the economy" further. The penalty for not seizing these opportunities now while the going is good is likely to worsen substantially in the years ahead. In the next millennium, the competitive heat of the global marketplace will intensify and so will the incentives for firms to outsource across borders. Especially if encumbered by too many injudicious laws and lawsuits, more U.S. businesses will simply off-load more of their operations. In the course of this industrial upheaval, millions of American workers are likely to be sacked or, at a minimum, to see their wages stagnate.

PRUDENT CORRECTIONS

Not unaware of this prospect, the 104th Congress made some tentative progress toward redressing abuses of the regulatory state. Legislation was passed requiring federal agencies to weigh the costs and benefits of major new mandates and to submit their studies to Congress for review. Narrower statutes were enacted eliminating zero-tolerance standards for health risks in some consumer goods (processed foods, for example) or at least requiring regulators to publish cost justifications for safety standards (as for drinking water). In an attempt to curb the excesses of what might be called privatized social regulation—in particular, the rampant civil litigation that purports to protect consumers—Congress succeeded in setting minimal limits on the rewards to shareholders and plaintiffs' attorneys for suing companies frivolously.

To call such steps anything but a bare

REGULATION

beginning, however, would be a delusion. The shareholder "strike" suits bill should have, but didn't, clear the way for a broader legal reform proposal that would have restricted punitive damages in product liability cases generally. (President Clinton vetoed both bills, but only one of his vetoes was overridden.) So far, the new procedural requirements for the formulation of executive rules, in turn, have proved mostly exhortatory. In only one case, the Pipeline Safety and Partnership Act of 1995, is an executive bureau expressly enjoined from promulgating standards whose costs are unjustified by benefits. In the rest, administrators are only asked to consider and report their cost-benefit assessments and to explain any rule-making that discards them. The provisions for congressional oversight of proposed rules are constrained by tight statutory time-frames, presidential veto power over resolutions of disapproval, and too limited a role for the legislative branch's top economic analysts. (The 1995 Unfunded Mandates Reform Act authorizes the Congressional Budget Office to "score" regulatory acts of Congress, but not those of the executive. The latter's rules, according to the Small Business Regulatory Enforcement Fairness Act of 1996, are to be examined by the General Accounting Office, arguably under unrealistic deadlines.) Perhaps least satisfactory is the grandfathering of existing laws and rulings. With a few notable exceptions—such as the Delaney clause, which barred any level of risk in food additives—old regulations, no matter how questionable, remain on the books.

Some of these deficiencies might be partially remedied by more fine-tuning. A pending bill, the so-called Regulatory Improvement Act authored by Senators Fred Thompson (R-TN) and Carl Levin (D-MI), would try to ensure, for instance, that agencies take seriously their evaluations and risk assessments of new rules by introducing a process of independent peer review. The bill would also extend methodically a similar

review process to extant regulations.

Even these corrections, however, will not suffice to sharpen the lines of political accountability for regulatory pork. A proliferation of agency analyses, peer committees, and reporting requirements is no substitute for democratic choice. Ultimately, the buck ought to stop with Congress itself, where members should have to cast transparent up or down votes on all the government's off-budget activism, just as votes are recorded on other important taxes and expenditures. But unless these decisions are well-informed, legislators will render them meaningless, if they render them at all. One way to minimize evasion might be to expand the capacity of the Congressional Budget Office to delineate for the legislature society's gains and losses from *every* major regulatory initiative, much as CBO performs this annual service with every big budgetary item. A joint report by the American Enterprise Institute and the Brookings Institution published last July suggested experimenting along these lines (see box, page 12).

Beyond these institutional adjustments lie larger priorities. Sooner or later, policymakers in the United States will have to face the fact that inordinate legal contestation pervades the way this society seeks to regulate itself. Much of this punitive "adversarial legalism," to borrow the apt description by Robert A. Kagan of the University of California, Berkeley, lines the pockets of lawyers and professional litigants while accomplishing little else. The resulting drag on American economic performance, though little noticed at the moment, may become considerably less affordable in time. Part and parcel of serious regulatory reform, therefore, has to be a reasonable contraction of federal enactments that stimulate, indeed sometimes sponsor, our seemingly insatiable appetite for litigation. This won't be easy, for it will mean rolling back an oversupply of suits everywhere, from the workplace to the doctor's office, as well as entertaining fewer complaints about sagging stock quotations, risky products, and many of life's hazards, misfortunes, and disappointments. ■

Congress & Regulatory Reform

The 1994 election of the first Republican Congress since the early Eisenhower years guaranteed a dramatic change in the political environment for regulation. No longer would the crafty auto-industry defender John Dingell (D-MI) chair the House Committee on Energy and Commerce (since renamed the Committee on Commerce). No longer would Dingell rule the oversight staff empire that made him the most feared regulatory micromanager in congressional history. Nor would Dingell's long-time adversary in clean air debates, environmental champion Henry Waxman (D-CA), hold the gavel at the Subcommittee on Health and the Environment. The election meant that these posts would pass to Republicans, two changes that, by themselves, augured a new day in regulatory politics.

Achievements and Prospects

Of course, the same thing would happen throughout Congress, assuring that federal regulators faced both a new set of overseers and a very different oversight message. Moreover, our Constitution allows Congress to pass any law it wants, provided that enough members want it and that not more than four Supreme Court justices object. On the other hand, a president, acting alone, can pass little more than his dinnertime mashed potatoes, and the 1994 elections clearly put President Clinton on the defensive politically. Thus some might have thought the situation conducive to far-reaching and fundamental statutory change in the pursuit of economic efficiency and scientific rationality.

But the legislative regulatory reform record of the past three years is decidedly mixed. Reform advocates have both won significant victories and encountered some predictable resistance. They have also made some avoidable mistakes. A look at where and how change has occurred thus far, and at where it has been stymied, should inform strategic thinking as the reform debate enters yet another congressional election, one overwhelmingly likely (if history is any guide) to leave Republicans in the driver's seat for at least two more years.

POLITICAL PARAMETERS

Above all, it is important to keep in mind what the 1994 and 1996 elections did not change. They did not reduce in any way the basic political appeal (even sanctity) of the public health and safety or of the environment—all of which lie at the focus of our most consistently contentious national regulatory efforts. For many years opinion surveys have found a durable base of support for safe products, clean water, and the like. This will not change.

Citizens (and especially economic constituencies that may be adversely

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affected by regulation, such as coal miners) do predictably balk at possible job losses. They also chafe at personally intrusive or tangibly burdensome regulatory decisions and programs (and at costly deregulatory policies, such as allowing cable television rates to climb). Pollution-reducing restrictions on personal automobile use would simply go too far for most Americans. Expensive or invasive vehicle inspection and maintenance regimes can evoke outcry even among liberal Democrats. Recall that in the mid-1970s Congress quickly disconnected the National Highway Traffic Safety Administration's automobile ignition interlock requirement (which prevented the start-up of a car until the seat belt had been buckled) and rebuffed a Food and Drug Administration proposal to ban saccharin as a possible human carcinogen. In both instances consumers were outraged and Congress responded. But none of this meant that citizens wanted to abolish either NHTSA or FDA. They simply wanted "common sense" restored to regulation.

Nor did the 1994 and 1996 elections change the occupant of the White House, a Democratic president with his own set of incentives and cards to play in the game of regulatory politics. As things now stand, unless congressional Republicans pass regulatory bills that President Clinton finds tolerable, or approve controversial proposals by veto-proof margins, statutory reform of regulation simply cannot proceed. Moreover, as Republicans now know all too well, by publicly deriding their legislative initiatives as dangerous to Americans (and especially to their kids) President Clinton can quickly seize the high ground and leave his opponents gasping for political air.

Certain scenarios are simply implausible. Barring discovery of some new

political alchemy, it is inconceivable for Clinton to endorse a revision of the Occupational Safety and Health Act (a statute that has stood virtually untouched since President Nixon signed it in 1970) if AFL-CIO president John Sweeney strongly opposes the bill. Clinton may be willing to antagonize organized labor on trade issues, but Al Gore can't afford to go into the next presidential election campaign having broken his February 1996 promise to the AFL-CIO executive council to keep workplace protections intact. And no major FDA reform will get very far in the current White House if the FDA commissioner (especially one as widely respected as former commissioner David Kessler) complains that it places consumers at unreasonable risk or unduly ties FDA's hands. Alternatively, funneling more resources to FDA to speed reviews of new drugs (as was done five years ago with the newly reauthorized Prescription Drug User Fee Act) is the kind of reform that both consumer-conscious liberals and enterprise-minded conservatives can embrace. Senators Orrin Hatch (R-UT) and Edward Kennedy (D-MA) jointly pushed for the legislation last time around.

Finally, as Pietro Nivola observes elsewhere in this issue, it is important to recognize a fundamental bipartisan appeal of policymaking via regulation: it gives politicians something to sell to voters for which relatively few government (and therefore tax) dollars need be found. Direct regulatory burdens are typically borne by regulated firms, not taxpayers. As economists regularly observe, cumulative social costs can be significant (and may be questionable from the perspective of cost-benefit analysis), but they have the virtue of not turning up in the federal budget or directly increasing the deficit. Environmental programs (most notably clean air compliance and hazardous waste cleanup) result in billions of dollars in

Christopher H. Foreman, Jr., is a senior fellow in the Brookings Governmental Studies program. He is author of Signals from the Hill: Congressional Oversight and the Challenge of Social Regulation (Yale University Press) and of The Promise and Peril of Environmental Justice, forthcoming from Brookings.

Six Recommendations for Federal Regulatory Reform

1. Congress should rewrite key regulatory statutes, such as those related to environmental protection, consumer safety, and workplace regulation, with the goal of achieving better results at lower cost. When necessary to fulfill that goal, Congress should devolve responsibility to the states.
2. The president and Congress should improve the quality of regulatory analysis. Congress should expand the capacity of the Office of Management and Budget and the Congressional Budget Office to review important laws and regulations. It should mandate the use of benefit-cost analysis in identifying and evaluating regulatory alternatives and select those that maximize expected net benefits. It should require that all new regulations costing more than \$100 million annually pass a broadly defined benefit-cost test.
3. Congress should require regulatory agencies to report each year to the American public on the quantifiable and nonquantifiable benefits and costs associated with their rules.
4. Congress should encourage the courts to use a rough benefit-cost standard in judicial review for all regulations.
5. Congress should scrutinize existing regulations as well as new ones. It should direct OMB and the rulemaking agencies themselves to review at least 10 important existing regulations each year to ensure that they are being implemented in the most cost-effective manner and to ensure that they produce benefits in excess of costs. Regulations that cannot be modified to pass such a test should be eliminated.
6. Congress should experiment with a regulatory budget for new regulations. It should set annual allowable limits for the regulatory costs imposed on society by regulations whose expected costs exceed the expected quantifiable benefits.

These recommendations are derived from *An Agenda for Federal Regulatory Reform*, by Robert W. Crandall, Christopher DeMuth, Robert W. Hahn, Robert E. Litan, Pietro S. Nivola, and Paul R. Portnoy (American Enterprise Institute and the Brookings Institution, 1997).

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private-sector and transaction costs yearly. By comparison, the direct costs of EPA's clean air and hazardous waste programs pale into insignificance.

CURBING COSTS, CRAFTING PROCEDURES

Anxious to tame the federal government and make good on their Contract with America, congressional Republicans scored a lightening-quick victory for cost-conscious regulation with the 1995 Unfunded Mandates Reform Act. As far back as the 1970s New York City's Democratic Mayor Ed Koch was regularly complaining about an onerous federal "mandate millstone" weighing on state and local governments. The new law required that estimates be made of the costs imposed on state, local, and tribal governments by major new federal initiatives, whether statutory (if greater than \$50 million) or administrative (if exceeding \$100 million). The law requires agencies to select "the least costly, most cost-effective, or least burdensome alternative" course for achieving their objectives.

A determined Congress signaled its desire for cost-conscious regulation through the Small Business Regulatory Enforcement Fairness Act and the regulatory accountability provision in the Omnibus Consolidated Appropriations Act of 1996. Of the two, only the former seems to have any real bite. It makes available new channels for small business to advocate its views before EPA and OSHA regulations are issued. It mandates congressional review of major regulations before they become effective, and it allows time for consideration of a joint resolution of disapproval (which requires a presidential signature). Of course, agencies are ever-sensitive to their political environments, and it will be a rare agency head who dares to risk a joint rebuke from both Congress and the president who appointed him or her. A safe bet is that this is most likely in the presumably rare

instance when (as with FDA's abortive saccharin ban 20 years ago) the agency concludes that the statutory instructions under which it operates—instructions crafted by a prior Congress—leave no choice but to offend current sentiments on the issue at hand.

As in earlier debates, a focus on generic regulatory review procedures has proved one politically feasible path to legislative consensus. Both congressional parties find legislative veto provisions (requiring the presentation of some general class of administrative actions to Congress before they take effect) appealing. Such provisions speak to a bipartisan concern with institutional power but do not single out or immediately threaten substantive regulatory programs (and their attentive constituencies). Old hands with long memories will recall a 94-0 Senate vote in March 1982 for similar legislation, which later died in the House.

THE (PARTIAL) DEATH OF DELANEY

But to get serious about legislative reform of regulation mostly requires getting a lot more specific. Particular substantive programs, and the statutes that authorize them, beckon. And it is here that both parties, at both ends of Pennsylvania Avenue, pulled off one of the more interesting, and instructive, legislative surprises in recent memory: the Food Quality Protection Act of 1996. This law abolished the long-debated, but long untouchable, Delaney clause in the Food, Drug, and Cosmetic Act as it applied to federal policy for agricultural pesticide residues in processed foods.

New York Congressman James Delaney inserted his famous clause into food and drug regulatory law some 40 years ago in response to rising public concern about cancer. The provision established a "zero tolerance, zero risk" framework for both food additives and pesticide residues: no detectable amount of either was permissible if it were found, through human or animal testing, to cause can-

cer. But over time, ever-more sensitive tests were able to identify substances at previously undetectable levels. As we went from measuring "parts per million" to "parts per trillion," and some scientists began openly questioning the rationale for an obsessive focus on trace amounts of artificial chemicals in foods, the Delaney framework appeared increasingly less realistic.

But simply rescinding the Delaney clause was politically unthinkable. As a House staffer once pointedly said to me, no legislator wanted to see the *New York Times* story in which voters were told that their representative has just increased their likelihood of developing cancer.

In the summer of 1996, with little warning and after intense but quiet negotiations on Capitol Hill, the political logjam suddenly broke. The new law specifies safety as meaning "a reasonable certainty that no harm will result from aggregate exposure." Observers cite several factors in the sudden turnaround: court decisions that threatened to force some pesticides off the market; Republican hunger for an environmental achievement; business desires for a consistent regulatory regime in which to operate; environmentalist (and EPA) interest in moving beyond a focus on cancer and processed foods; and simple exhaustion, and desire for a deal, among all parties concerned.

The central political secret of the new law is simply that it offers key benefits for business along with new elements that arguably *strengthen* consumer health protections. The new law embraces both raw and processed foods for the first time; rigidly restricts the circumstances under which social benefits may be considered when setting residue tolerance levels; and provides for expanded re-registration of existing pesticides. The industry complaint that a scientifically insupportable Delaney regime remains applicable to food additives and other substances will almost certainly have to be met with similar political creativity, allowing business and health advocates to emerge victorious.

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CRISIS RESPONSE: DÉJÀ VU ALL OVER AGAIN

Changed health and safety regulatory statutes also continue to be especially likely in the same circumstances that have made them possible historically: the political need, and political opportunity, presented by a new or newly salient threat to the public health. Deregulators and regulatory reformers of all sorts have little choice but to respond to unforeseeable events on a case-by-case basis. From its beginnings in 1906 the history of FDA has largely been defined by a continuing series of crisis-inspired statutes. The deaths of some 100 people who had ingested a contaminated elixir propelled a major 1938 revision of the law, and Europe's thalidomide tragedy helped create a congressional climate favorable to passage of the 1962 drug amendments requiring, for the first time, that drugs be evaluated for efficacy as well as safety. Since then, defective intrauterine devices, painkillers, and infant formula have all given rise to new statutory authority for FDA, much as the crisis at Love Canal turned EPA into the custodian of a much-maligned Superfund hazardous waste cleanup program.

Today bacteria-tainted hamburger has revived calls for FDA and the Agriculture Department (responsible for meat and poultry safety) to have the authority to compel product recalls instead of pleading (in and out of court) for them. Food industry lobbies continue to resist giving FDA and USDA this power, believing it unnecessary. Advocates observe, by comparison, that NHTSA can order automobile recalls. But consider the differences in stakes, in political culture, and in consumer sensitivity. A handful of vertically integrated firms can far more easily respond to a recall order, and absorb its costs, than a small cannery or slaughterhouse, which may reasonably fear being put out of business. Farmers and cattlemen are also likely to harbor strong suspicions of

Washington. And consumers, on average, are probably more nervous about any defect in the foods they eat than in the cars they drive. Lawmaking will have to take account of such factors to be successful. One beneficial effect of recent food safety scares, and of the resulting desperate search for solutions, has been FDA approval of an apparently reliable but long-neglected (some would say suppressed) technological option: the irradiation of foods to kill disease-causing microbes.

NO MONKEY WRENCHING ALLOWED

If Republicans committed any single strategic blunder after their congressional takeover, it was allowing their opponents plausibly to accuse them of trying to kill the regulatory patient they said they wanted to save. The congressional leadership tried to embrace a "silver bullet" approach to reform, amending all regulatory statutes simultaneously in a single statute mandating generic procedural and analytic requirements. This would spare Republicans the need to fight a multi-front war of attrition on every separate statutory authorization. As noted above, they got some of what they wanted. But this strategy, and the tone of the debate that ensued, also allowed critics to portray what they were up to as insidious deregulation on-the-sly, what Jessica Mathews, writing in the *Washington Post*, later dismissed as a "sand-in-the-crankcase" approach to regulatory reform. A group of experts affiliated with the Brookings Institution, the American Enterprise Institute, and Resources for the Future recently recommended that Congress "rewrite key regulatory statutes" to encourage more flexible, cost-conscious regulation and a greater role for the states in managing "problems that can be better handled there" (see box). The debate should be thoughtful and honest. It will no doubt be contentious, and demagogic rhetoric on both sides is always a possibility. And to win, the Republican congressional majority must persuade instead of evade. ■

Smoke and Mirrors



Understanding the New Scheme for Cigarette Regulation

Last June, U.S. cigarette companies, together with government

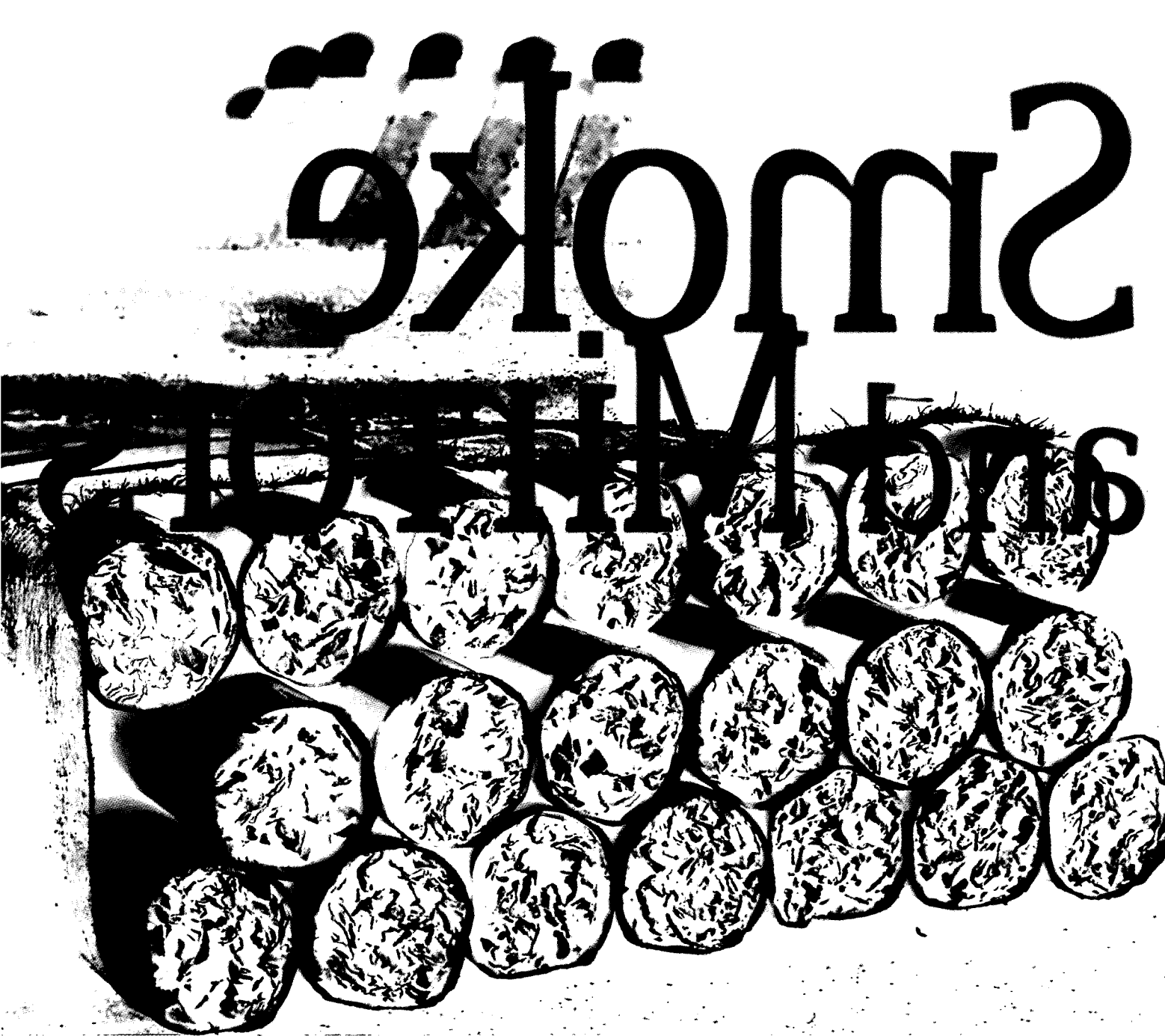
officials, chiefly state attorneys general, drafted proposed federal legislation that would, if enacted, have a sweeping effect on the regulation of cigarettes, as well as on prospective cigarette industry liability.

Cigarette regulation is nothing new. Cigarettes have long been subject to heavy excise taxes at both the state and federal level, and Congress has mandated on-product warnings and written the warning language for cigarettes since 1964. Cigarettes have also been the target of decades of litigation, though here the cigarette industry has enjoyed an almost

BY W. KIP VISCUSI

unblemished record of success.

By 1997, however, the cigarette industry had been hit by a flurry of 40 state lawsuits seeking reimbursement for the health insurance costs associated with smoking. These suits, based on as yet untested legal theory, have led to multibillion dollar out-of-court settlements in Mississippi and Florida. They also prompted the legislative proposal, which would establish a reimbursement formula for all states. This article explores the nature of this proposed resolution, its implications for the cigarette industry, and its merits from the standpoint of social efficiency.



H. ARMSTRONG ROBERTS

THE PRICE TAG

Public understanding of the settlement may extend little beyond a single number—the widely publicized \$368.5 billion face value of the first 25 years of cigarette industry payments. The first payment, \$10 billion up front, would be followed by annual payments rising from \$8.5 billion the first year to \$15 billion in 5 years. The payments do not end after 25 years, but continue in perpetuity so that focusing only on the first 25 years understates the long-run implications of what is at stake.

W. Kip Viscusi is John F. Cogan, Jr., Professor of Law and Economics and Director of the Program on Empirical Legal Studies at the Harvard Law School.

The timing of the payments is not inconsequential. Although payment amounts will be adjusted upward over time to reflect price increases (by 3 percent or the percentage increase in the consumer price index, whichever is greater), the settlement price tag of \$368.5 billion is not discounted to reflect its present value. If we were to discount the settlement payments using a 3 percent real rate of interest, the present value of the first 25 years of payments would be \$255.6 billion, with a present value in perpetuity of \$494.4 billion. Because of possible disagreements about the rate of discount, the focus has been on the total undiscounted package value.

The more important complication is that the value of the payments will vary proportionately with the unit sales volume of tobacco products. If cigarette consumption were to drop by one-fourth, the settlement payments would fall similarly.

Because of the sales volume linkage, the best way to think about the settlement is in terms of the cost per pack: the payment is equivalent to an additional 62¢ per pack tax. State and federal taxes already total 56¢ a pack for an annual total of more than \$13 billion. The new levy would bring the total tax per pack to \$1.18. Recently President Clinton voiced support for raising the additional tax to \$1.50 per pack, the same figure in Senator Edward Kennedy's legislative proposal.



cigarette prices would cause a 4–7 percent drop in smoking overall, it would cause smoking by teenagers to fall 12–14 percent. Thus the tax is particularly effective in discouraging youth smoking.

Another noteworthy distributional aspect of the taxes is that cigarette smokers tend to be poorer and more likely to be blue-collar workers than the average American. Indeed, cigarette taxes are regressive not only in terms of

the percentage of income going toward the tax, but also in absolute terms. Those in lower income groups pay more in terms of the total dollars of cigarettes taxes than the very affluent. If Congress passes this proposed resolution, the maintenance workers at the Capitol will pay more of the tax than the members of Congress who voted for the legislation. Such concerns may have led to the failure to enact a cigarette tax as part of the mid-1990s health insurance proposals.

THE ROLE OF TAXES

Taxes have a variety of functions, from raising money for the government, to penalizing behavior some may view as immoral, to helping align private and social incentives. If, for example, smokers impose net costs on others, taxes can discourage smoking, reducing it to the level that would be observed if smokers took full account of the consequences of their actions. Similarly, if smokers are making mistaken decisions that harm their future welfare, taxes can discourage these decisions just as would, for example, a more accurate understanding of the hazards of cigarettes.

Although the cost of the tax will be shared by consumers and firms (for firms will lose profits as sales drop), most of the cost of the tax will be borne by consumers. Tobacco industry payments could be structured differently—for example, as a lump sum tax on companies rather than as a per unit tax—so that costs would be borne solely by tobacco producers. But such a tax would do nothing to discourage smoking or align private and social incentives.

Antismoking critics of the proposed settlement want to have it both ways. They like per unit taxes because they discourage consumption and reduce societal smoking rates. But they want companies to bear all the tax, and they want payments to the government to remain the same even as sales decline.

The form the tax takes will affect whether it primarily decreases consumption or profitability. From the standpoint of social efficiency, it makes the most sense to link the tax to cigarette consumption if our intent is to make product purchasers recognize the social costs of their smoking decision.

The differential effects of the tax are of particular interest. Younger smokers tend to be more responsive to cigarette prices than older smokers are. Whereas a 10 percent jump in

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THE ROLE OF THE STATES

The 40 lawsuits filed against the cigarette industry represented an unprecedented attempt by state governments to recoup the insurance-related costs of a product. As the issue was framed by the states, the focus was a narrow one—the total increase in medical costs arising from cigarette smoking. Other human health effects and other welfare consequences of smoking were excluded.

Framed thus, what has been the cost to the states? The answer depends in large part on what one chooses to count. Table 1 summarizes my cost calculations for the two states that have settled out of court as well as for the two states for which litigation is most imminent. The medical care costs range from 1.7¢ per pack in Mississippi to 3.1¢ in Minnesota. Because smokers tend to be sicker than nonsmokers, their medical costs to the state, chiefly Medicaid, are higher. Focusing only on this cost indeed increases costs to the states, though

far less than claimed in the lawsuits.

More comprehensive cost tallies, however, give a different view. Consider the estimates for the state of Florida. Because of smokers' shorter life spans, they pay 1.6¢ per pack less in earnings taxes to the state than nonsmokers, but they also save the states 7.5¢ per pack in nursing home care costs and 5.2¢ per pack in pension costs. The total net savings is 7.9¢ per pack, so that Florida gains overall.

What would happen if in fact one concluded that cigarettes did impose a net insurance cost on the states? One could presumably recoup these costs through litigation, though at substantial additional cost. Another approach is simply to impose the tax at the time of purchase through an excise tax. Such excise taxes already exist, and they range from 18¢ per pack to 48¢ per pack for the four states in table 1. Thus, taking into account excise taxes, the states gain from 21.2¢ per pack to 56.6¢ per pack.

Even if one considers only the medical effects of smoking, however, nursing home expenditures should logically be included in these net calculations. And when they are, cigarettes on balance pay for themselves in terms of their medical insurance consequences for state governments.

WHY THE COST COUNTING DIFFERS

A dizzying array of figures has appeared in the press and in public debates over the costs of cigarette smoking. The primary reason for the wide range of numbers, of course, is the scope of what is included in the cost calculations. The states, as noted, use only the top row in table 1 in assessing their medical care expenditures.

But there are other reasons why such a seemingly straightforward economic exercise as calculating the costs associated with cigarettes could lead to so many different results. One springs from flaws in the way states calculate medical expenditures. First, states often estimate the medical care expenditures assuming that smokers live as long as nonsmokers—in effect charging smokers for their medical expenses after they are dead based on their relative

Table 1. Financial Effects of Cigarettes on the States (cents per pack)

	Mississippi	Florida	Texas	Minnesota
Net Financial Costs				
Medical care	1.7	2.6	2.4	3.1
Taxes on earnings	1.4	1.6	1.6	1.8
Nursing homes	-2.5	-7.5	-6.9	-7.8
Pensions	-4.3	-5.2	-3.2	-6.3
Total*	-3.2	-7.9	-5.6	-8.6
Costs Including Taxes				
Excise taxes	-18.0	-33.9	-41.0	-48.0
Net state costs	-21.2	-41.8	-46.6	-56.6

*Total includes other effects not itemized, such as sick leave and fires.

medical costs while alive. Second, state calculations often take no account of the fact that smokers have other demographic characteristics that lead to higher medical costs. Smokers, for example, are more likely to work in risky jobs and to be injured on them. Third, the estimates for the state medical costs generally exclude the share of costs that will be reimbursed by the federal government. Thus, the states are attempting to collect twice for this portion of the costs—once from the cigarette companies and a second time from Washington. The states argue that this reimbursement is a collateral source and should not be considered. The calculations reported above isolated only the portion of the costs borne by the states.

Finally, many of the widely varying cost estimates refer not to the states, but rather to the nation, including the federal government. The scale of these costs is much greater, but the general story line is the same.

Smokers have higher medical care costs of 58¢ per pack, with nursing home care savings of 23¢ per pack and pension savings of \$1.25 per pack. The total net insurance cost of smoking is a cost *savings* of 32¢ per pack—in addition to the excise taxes paid on cigarettes. The general spirit of this conclusion is consistent with other studies in the literature.

NONPRICE COMPONENTS OF THE PROPOSAL

Although the primary focus of the settlement has been on its impressive price tag, the agreement would also lead to sweeping nonprice regulatory measures. The Food and Drug Administration would take on broad authority to regulate cigarettes, and the marketing and advertising of cigarettes would change dramatically.

Cigarette packages would have a new series of nine rotating warnings, all bolder and stronger than those used now. Outdoor advertising of cigarettes would be banned, as would the use of cartoon characters, such as Joe Camel, and human figures, such as the Marlboro man, in advertising. Except in adults-only facilities and publications, cigarette companies would be restricted to black text advertising. The federal government would launch a \$500 million annual antismoking ad campaign, as well as a variety of other antismoking efforts, such as federal public smoking standards.

Both the nonprice regulatory provisions and the financial costs associated with the proposal will lower cigarette consumption. As sales decline, so too will the amounts paid by the tobacco industry as part of the settlement. Some have criticized the decrease in revenues without understanding that the lower revenues necessarily will accompany reduced consumption achieved through higher cigarette prices.

UNDERAGE SMOKERS

The proposed legislation includes a wide variety of measures targeted at reducing underage smoking. In addition to setting a minimum age of 18 to purchase tobacco products, it would require photo identification of anyone under age 27, ban the sale of tobacco products through vending machines, ban self-service displays of tobacco products except in adults-only facilities, license retail tobacco product sellers and require conformance with the terms of the license as a condition for holding it, impose penalties for violations, and decrease payments to states that do not meet the “no sales to minors” performance targets. Such stringent, carefully structured efforts are well suited to addressing a problem restricted to a segment of the smoking population.

The higher prices that will be charged for cigarettes will also, as noted, discourage consumption. Because the responsiveness of the demand for cigarettes by teenagers is roughly three times that of adults, the higher prices will probably lower their consumption much more than that of adults.

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The proposed legislation establishes a series of targets for reducing youth smoking: a 30 percent decline in underage use of cigarette products within 5 years, a 50 percent decline within 7 years, and a 60 percent decline within 10 years. If these targets are not met, additional “look-back” provisions would increase the penalties by up to \$2 billion per year.

Much of the impetus for the proposed \$1.50 per pack cigarette tax is that a 62¢ tax alone will not discourage consumption sufficiently to meet the stated targets. The estimates of the effect of the 62¢ tax, however, neglect the role of the nonprice measures as well as the mark-up that will occur on the taxes before they reach the retail level.

A more basic concern about using price as the principal policy lever for discouraging youth smoking is that most cigarettes are not purchased by underage smokers. Depending on the particular study, it appears that roughly 95–97 percent of all cigarettes are purchased by those over 18 years of age. Increasing prices for all consumers is thus a blunt policy instrument for discouraging youth smoking. It will impose substantial costs on people who are of legal smoking age and too often are relatively poor. Policies specifically targeted at reducing underage smoking can foster this policy objective more equitably.

WHAT TOBACCO FIRMS GET

Not all the provisions in the proposed legislation favor the states. Others, pertaining primarily to civil liability, are favorable to the financial health of the cigarette industry.

Most important, the legislation would end all present and future actions by state attorneys general. Cigarette companies would escape the potential liability they could face because of an unfavorable ruling about which costs count or because of an unpredictable jury.

The settlement would also preclude all future “addiction” or dependence claims, all class actions, and all claims for punitive damages. Individuals, however, could still sue for past conduct, so that in the long run the industry would not be free of the current set of liability concerns.

The value of these restrictions on liability is hard to assess. Certainly the tobacco company payments stipulated by the legislation greatly exceed any liability sum that would be estimated based on past success rates in litigation. But the stakes involved are enormous, with the outcomes being highly correlated. Losing one state suit, for example, greatly increases the likelihood of losing others. Addiction claims likewise could snowball if the cigarette industry developed a losing track record. The global settlement gives the industry a safe harbor from the vagaries of the tort system and the randomness of jury awards.

The proposed settlement would not provide for compensation of the plaintiffs' lawyers, but parallel agreements would lead to such payouts. Total fees to lawyers will be in the billions. Indeed, the private lawyers retained by Florida are seeking contingency fee payments of \$2.8 billion, or 25 percent of the total settlement, an amount that dwarfs their actual legal expenses, much of which were incurred after the national settlement was proposed, making compensation likely. In its initial review, the court rejected this legal fee claim, noting that "\$2.8 billion simply shocks the conscience of the court."

The role of the private attorneys in cigarette lawsuits has generally come under increased scrutiny. When, for example, a recent class-action lawsuit by flight attendants was settled out of court, the flight attendants received no financial compensation, but the trial lawyers received \$49 million—again, a sum far in excess of their legal expenses. Genuine concern is developing that the plaintiffs' lawyers in various tobacco suits should receive compensation for their legitimate expenses, but not windfall gains.

TOWARD A RATIONAL SMOKING POLICY

If a global settlement is ultimately approved by Congress, it will presumably be somewhere between the initial proposal and the \$1.50 per pack levy endorsed by the president and Senator Kennedy. Once these financial and liability issues are settled, the more important concern will be how society addresses smoking behavior.

Much of the disagreement to date stems from a confusion on the part of the antismoking forces over whether their goal is to harm the cigarette industry or to help consumers. The

most sensible basis for policy is to foster rational and informed smoking decisions. As a practical matter, such an approach should lead policymakers to embrace rather than condemn technological improvements that enhance the safety of cigarettes. The smokeless cigarettes introduced by R.J. Reynolds—the Eclipse and the Premier—would have

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In almost every other area of health and safety regulation, Washington has promoted and often required technological improvements to enhance safety. It can play a similarly supportive role for cigarettes by encouraging innovations to reduce health risks and expand consumer choice.

greatly diminished the cancer risk associated with smoking, yet leading public health officials attacked the new cigarettes as nicotine delivery devices rather than urging consumers to experiment with this clearly safer product. In much the same way, the recent development by Philip Morris of a smoking box that would trap side stream smoke and reduce environmental tobacco risks and exposures has been the object of ridicule.

In almost every other area of health and safety regulation, Washington has promoted and often required technological improvements to enhance safety. It can play a similarly supportive role for cigarettes by encouraging innovations to reduce health risks and expand consumer choice.

Critics contend that we may not know what innovations are safer or how much safety they provide. Often, indeed, there is real uncertainty: will filtered cigarettes raise or reduce the risk? More drastic innovations, however, such as the denicotined cigarette and the smokeless cigarette, should raise far less doubt as to their efficacy. And the existence of some uncertainty provides all the more reason for the government to take the lead in identifying the comparative product risks.

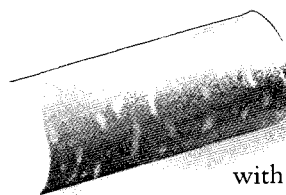
The government should establish a standardized rating system to assess the relative risks of cigarettes so that consumers can make informed choices. Providing information about tar and nicotine levels alone is not enough: it may not, for example, capture carbon

monoxide risks of smokeless cigarettes. The cigarette companies are in a difficult position

with respect to all such matters since they are not permitted to

make health claims on behalf of their products. They can make only oblique claims, such as saying a cigarette is "smoother" or "light." Fostering safety innovations and providing the information that enables consumers to choose safer cigarettes remains a neglected component of the government's smoking policies.

A primary reason for such neglect is a governmental mind-set that is anti-industry. State and federal governments alike should abandon their combative stance, take a more open-minded approach to the safety of tobacco products, and make advancement of consumer welfare their paramount concern.



Deregulating Campaign Finance

Solution or Chimera?

The reports of widespread fundraising abuses in the 1996 elections have precipitated another heated debate about whether and how best to alter the rules under which money is raised and spent to influence federal elections. Alleged violations of existing laws—fundraising from foreign nationals, the use of conduits to mask impermissible contributions, improper use of public property for fundraising events and telephone calls, and the use of soft money and issue advocacy to circumvent spending limits on publicly funded presidential candidates—have led to calls for aggressive criminal prosecution (preferably led by an independent counsel) and for legislative action to plug the legal loopholes that have encouraged or abetted reprehensible conduct by candidates, parties, and outside groups.

In spite of the colorful (and appalling) new material from 1996, much of the reform rhetoric is stale, reflecting arguments that have been marshaled time and again during the futile debates of the past 15 years. But there is one decidedly new kid on the reform block, a proposal breathtaking in its boldness and contrariness. Introduced by Rep. John Doolittle (R-CA) and championed by the estimable columnists Charles Krauthammer, Robert Samuelson, and George Will, H.R. 965 (the “Citizen Legislature and Political Freedom Act”) would remove all existing limits on contributions to federal candidates and national parties, end the public financing of presidential primary and general election campaigns, and mandate electronic filing and timely disclosure on the Internet of reports on contributions to candidates for federal office. Faced with widespread evidence of perverse effects and unanticipated consequences from previous efforts to regulate the flow of money in elections, Doolittle and his supporters appear to take a lesson

from the largely successful experience with deregulation of the intercity transportation, energy, and financial services industries. In addition to the obvious virtue of simplicity, this call to “deregulate and disclose”—and let the chips fall where they may—offers a vision of a political marketplace disciplined not by a legal thicket of arcane rules and zealous regulators but by rational citizens exercising their franchise.

Part of the appeal of the Doolittle approach is that it explicitly rejects a regulatory model that by virtually all accounts has failed utterly to achieve its objectives. Present law regulating the financing of congressional elections restricts the supply of funds (through contribution limits whose real value has eroded by two-thirds since enactment in 1974) but not demand (since the mandatory spending limits in the law were declared unconstitutional by the Supreme Court). Is it any surprise that this hybrid system has intensified the money chase and stimulated the development of a black market for raising and spending funds to influence the outcome of House and Senate elections? The rules governing the financing of presidential elections (with voluntary spending limits achieved through the provision of generous, inflation-adjusted public financing) were built on a more plausi-

Thomas E. Mann is director of the Brookings Governmental Studies program and co-editor of Campaign Finance Reform: A Sourcebook (Brookings, 1997).

ble regulatory model, and for a while they worked largely in the manner anticipated by their architects. But a series of Federal Election Commission rulings beginning in 1978 created an alternative currency, not subject to federal regulation, that proved irresistible to ambitious politicians and resourceful consultants. By 1996 the scramble for this alternative currency (otherwise known as soft money) and its expenditure for what were ostensibly ads about "issues" and not candidates made a mockery of the legal prohibitions and limits on contributions and the voluntary spending limits.

Patching the holes in this regulatory regime is a daunting task, especially in light of the restrictions on policymakers imposed by the *Buckley* Court's holding that money is speech under the First Amendment and can be regulated only if there is

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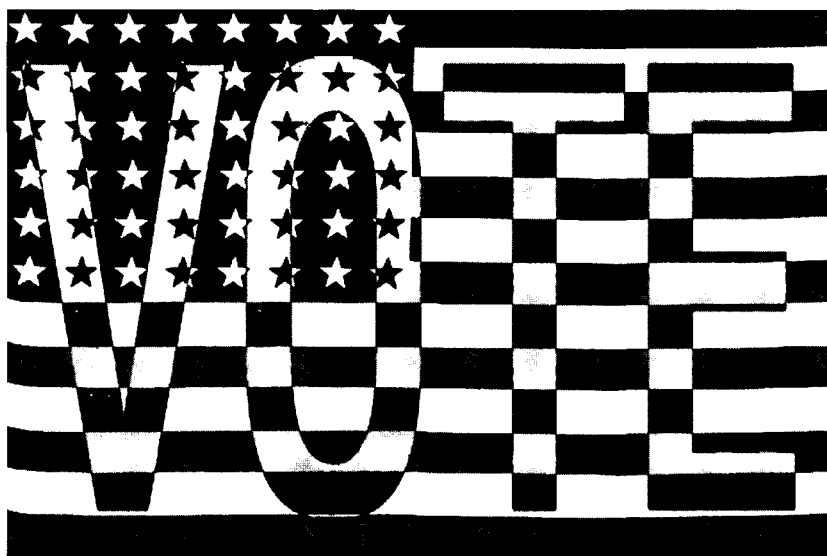
state power? To do so, they would need to acquire full information on who was giving what to which candidates and parties; be able to differentiate between the opposing candidates or parties in the pattern of campaign contributions; and have a strong incentive to cast their ballots on a single basis: to punish a candidate or party for accepting funds that they find repugnant. It is hard to see how any *one*, much less all three, of these conditions could be met in the brave new campaign finance world sketched by Representative Doolittle—given the more realistic world described by Anthony Downs of voters rationally limiting the time they invest in pursuing information about politics.

First, take full information. The Doolittle bill does nothing to require disclosure of campaign activity disguised as issue advocacy—the most rapidly growing, the most negative, and the least accountable form of political communication. Assuming the rest is disclosed on the Internet, how are voters to obtain and absorb copious data on campaign contributions? The press can help, but its voice might easily be drowned out by the political ads financed with the unregulated contributions that are supposed to be disciplined by an informed electorate. The Doolittle proposal also underestimates the extent to which full disclosure itself requires an extensive regulatory apparatus—just the thing Doolittle promises to abolish.

Second, even assuming they garner the necessary information, will voters be presented with a clear difference in fundraising behavior on which to cast their ballots? What is to prevent large economic interests from investing generously in both parties or contributing to winning candidates after the election, in a quest for better access or in response to heavy-handed requests from those public officials? Each party or pair of candidates might attract campaign contributions, albeit from different sources, that voters find equally offensive.

Finally, why would voters sublimate those forces that now weigh heavily on their vote (party identification, political ideology, positions on key issues, economic performance, and the relative attractiveness of the candidates) in the single-minded pursuit of exercising the moral opprobrium that disciplines the role of money in politics? Experience with campaign finance disclosure over the past two decades suggests that citizens are less likely to vote on the basis of this new information than to conclude that the entire system is corrupt.

A deregulated campaign finance system is less a solution to the clear shortcomings of the existing regulatory model than a fanciful exercise in wishing those problems out of existence. The unrestrained use of economic wealth and state power in the electoral process would so clearly subvert the essential nature of our democracy that it would almost certainly lead to insistent public demands for the reregulation of campaign finance. There may be an alternative to muddling through the complexity of the present system. But if there is, it has yet to be persuasively articulated. ■



a compelling interest in doing so—and only if the rules are narrowly tailored to advance that interest. Increasing the supply of funds (through higher individual and party contribution limits and tax credits) and subsidies (with free broadcast time and mailings) seems essential, as does an insistence that federal campaign activity be financed exclusively with regulated—that is, "hard" money—funds. But this approach is exceedingly complex, both technically and politically, and the solution will be temporary at best, requiring ongoing oversight and repair. All the more reason, say Doolittle advocates, to rely instead on the invisible hand of the political market to allocate campaign resources by disciplining the candidates who raise and spend those funds.

"Deregulate and disclose" is a seductive slogan. But will it have the desired effects? Recall that a fundamental objective of campaign finance regulation is to ensure that the inequalities generated by the market economy do not undermine the political equality that is a central feature of our democracy. Another key objective is to prevent incumbent officeholders from abusing state power to extract private contributions to undermine the competitiveness of elections. Under the Doolittle plan would voters be able to limit the extent to which campaign donations and expenditures reinforce or magnify the influence of concentrated economic wealth and

Environmental Protection & the States



"Race to the Bottom"

When Congress laid the foundation for today's environmental regulation in the early 1970s, the idea that states inevitably cut corners in pollution control and conservation to attract business was a powerful argument for national action. When industrial debris in Cleveland's Cuyahoga River caught fire and oil from an offshore blowout blighted Santa Barbara's beaches in 1969, the incidents became national symbols of a "race to the bottom" in state and local politics.

BY MARY GRAHAM

H. ARMSTRONG ROBERTS

Recently, this view has gained new support. Not long ago, the press carried graphic accounts of hog wastes washing down Virginia's Pagan River toward the Chesapeake Bay from a plant owned by Smithfield Foods, Inc., the East Coast's largest producer of pork products. Lax state enforcement of national water pollution laws "could create 'pollution havens'" and "lead to a

shift of manufacturing and jobs that would penalize the conscientious states," the *New York Times* editorialized.

But the race to the bottom idea is too simplistic to describe the forces that shape state environmental policies in the 1990s. The idea is outdated for three reasons. First, evidence is by now overwhelming that businesses rarely decide where to locate or expand

based on the strength or weakness of state environmental programs. Second, state politics have been transformed in ways that make it more likely that pollution and conservation issues will get a fair hearing, independent of federal action. Finally, and most important, public attitudes have changed. Today, states compete to gain prosperity in a fast-changing economy. After nearly 30 years of government action and scientific progress, government officials, business executives, and voters find that some environmental measures aid in that contest. There is growing evidence that some states lead in economic growth and environmental protection, while other states lag behind in both.

To call attention to these changes is not to deny that state and local governments face tough trade-offs, that businesses often lobby to weaken environmental rules, or that some polluters still try to beat the system. Hiring inspectors to enforce the law or buying land to protect a watershed is expensive and must vie for limited state funds with improving schools, building roads, and paying for Medicaid and welfare. Environmental issues continue to be contentious because they often do pit jobs against cleaner air or more conservation, and sometimes both choices offer economic benefits. When stakes are high, business, labor, homeowners, and other groups will fight for their interests. And, of course, there will always be cheaters.

Thirty years ago, the assumption that there was a race to the bottom among the states was important because Congress was debating the need for a national framework of environmental protection. That question is now settled. Mainstream Democrats and Republicans agree that air pollution, water pollution, and other environmental problems that cross state lines should continue to be controlled by federal rules. Because most of our daily attention is drawn to hard-fought battles at the perimeter of government authority, it is easy to forget that we

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have witnessed an exceptional event in the past three decades: the successful introduction of a new theme in national policy.

Today, the question of whether states shortchange environmental protection to attract business is important for different reasons. First, we have reached a turning point in national environmental policy in which some readjustment of federal and state roles is inevitable. Thanks in part to the considerable success of national laws aimed at controlling major sources of pollution and encouraging conservation on large tracts of federal land, public attention is now turning to problems that are harder to solve from Washington. The next generation of environmental policies will tackle widely scattered sources of pollution and conservation opportunities that affect farms and housing developments as well as forests and meadows.

Second, both Democrats and Republicans are calling for new approaches to the first generation of environmental problems in order to give more flexibility to states. Frustration with the high costs and rigidity of "command and control" regulations has prompted moves to supplement those rules with market incentives, negotiated agreements, industry standards, and other techniques that decentralize decisions.

Third, the reach of federal regulation may be overly broad. The National Academy of Public Administration has suggested, for example, that controlling chemical contaminants in drinking water and deciding when, where, and how to clean up hazardous waste might better be done by state and local governments.

Continuing confusion about the capabilities of state governments is costly. Much-needed revisions of three of the legal cornerstones of national environmental policy—the Superfund, Clean Water, and Endangered Species

Acts—are stalled in Congress in part because of troublesome questions about how federal and state governments should share authority.

BUSINESSES HAVE CHANGED

In the 1970s, sudden new pollution control requirements with short deadlines called for large, unplanned investments that were extremely costly to some industries. Today, environmental costs rarely determine business location because they have become a relatively small and usually predictable element of corporate expenses. Even for chemical and petroleum industries, annual pollution abatement expenses run less than 2 percent of sales. Capital costs for pollution control vary widely from one industry to another, ranging from 2 percent of total capital costs for machinery and 3 percent for electronics to 13 percent for chemical industries and 25 percent for petroleum and coal. Even when substantial, though, those costs are usually dwarfed by labor, real estate, transportation, energy, and tax considerations in relocation decisions, according to surveys of corporate executives. One caveat, though. Sudden changes in pollution rules can sometimes close down individual factories and destroy jobs. Retrofitting old factories can be extremely expensive, and small or marginal businesses cannot always survive government demands to make changes.

Empirical evidence confirms that the rigor of state environmental policies generally has little influence on business location. Economists, who have found the issue hard to analyze because of the paucity of information about business relocation and the complexity of environmental policy, have generally found no strong association between environmental compliance costs and business location. Studies during the Reagan administration, when national oversight lessened, found no evidence of businesses moving in search of pollution havens. Likewise, there is little evidence

Mary Graham is a fellow at Harvard University's Kennedy School of Government. This article is adapted from a longer version published in the winter issue of The American Prospect.

that international businesses seek pollution havens, according to a recent report by the Organization for Economic Cooperation and Development.

At times, businesses may choose a high standard of environmental protection for reasons having nothing to do with state law. Investors stung by plummeting Rust Belt stock prices in the 1970s, when companies predicted devastating costs to comply with the first wave of environmental laws, now want to know that firms have planned for new requirements. And firms with plants in many locations may find it economical to adhere to a single set of environmental standards.

STATES HAVE CHANGED

States in the 1990s bear little resemblance to states in the 1960s, and their role in environmental protection has fundamentally changed. As political entities, they have been transformed by growth of professional staffs, vigorous two-party systems, use of referenda and initiatives to make policy, and procedural requirements that assure greater public participation in regulatory decisions.

Many aspects of environmental protection have been assimilated into state and local politics, as they have been into national politics. Political scientist Barry Rabe notes in *Environmental Protection in the 1990s* that about 70 percent of important environmental legislation enacted by the states now has little or nothing to do with national policy and only about 20 percent of the \$10 billion that states now spend annually on environment and natural resources comes from Washington. State and local governments are responsible for nearly all the enforcement of national environmental laws and continue to dominate decisions in areas like land use and waste disposal. Occasionally, states have cooperated to spread the costs of addressing a complex problem or to concentrate pressures for action among affected states. Lax enforcement still occurs, of course, but it is more likely to be checked by political interests within the state.

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PUBLIC ATTITUDES HAVE CHANGED

Finally, the idea that states routinely minimize environmental protection to attract business is outdated because we have learned a few things in the past 25 years about the benefits—and costs—of environmental protection. Even without a federal prod, voters have shown that they are sometimes willing to pay for state or local clean-up or conservation if they can reap the rewards. Environmental measures that contribute to critical infrastructure, attract skilled workers, or satisfy the needs of particular businesses are rightly seen as having economic value.

Governors and legislators support environmental proposals that promote safe drinking water or provide adequate sanitation not because Washington requires it but because public health is a precondition to prosperity. Voters approve measures that improve an area's appeal as a place to live and work in part because catering to the preferences of skilled workers can enhance economic growth. And tourism (accounting for nearly 10 percent of U.S. jobs in 1995) is not the only business with a direct interest in pollution control or conservation. Firms that require large amounts of pure water, for example—computer-chip manufacturers, food-processing companies, and breweries, to name a few—have economic incentives to keep streams, rivers, and groundwater uncontaminated.

At the other extreme, spending money to clean up pollution that drifts, flows, seeps, or can be transported into other states is likely to be viewed as a poor prospect by state politicians. And giving up prime development land to protect endangered species is usually seen as offering scant economic or political benefits. Environmental scientists must consider effects of development on future generations. State politicians usually can't. When poor investments for states are priorities for the nation, rigorous federal oversight is needed.

A RACE TO THE BOTTOM LINE

In general, though, support for environmental protection is a result, not a cause, of prosperity. At least at the extremes, states with strong economies tend to support relatively strong environmental protection programs while those with weak economies often support weaker programs.

In the 1990s, the real competition among states is not a race to the bottom to minimize environmental protection, but a race to the bottom line to improve property values and increase tax revenues. States compete to gain prosperity in an economy where firms are consolidating, capital is increasingly mobile, and skilled workers are sometimes in short supply.

Because experience has shown that wealthy economies devote more resources to environmental protection than do struggling ones, we should be concerned about the future of pollution control and conservation in relatively poor states.

Some research has suggested direct links between prosperity and environmental protection. An analysis by the Institute for Southern Studies in 1994 found that 9 of the 12 states that were strongest in environmental protection also were strongest in economic growth, while 12 of the 14 states that were weakest in environmental protection also ranked among the lowest in economic growth. States that have been dependent on oil, timber, mining, or other natural resource industries may face special problems with improving environmental protection and with assembling the ingredients of lasting growth.

Such differences among states are not surprising. State boundaries were drawn by accidents of settlement and political compromise, not by a desire for equity. Those chance divisions have produced variations in political culture and history that, in general, we celebrate. They have also produced variations in natural resources and taxable assets. State environmental protection, which lies at a junction of economic forces, political will, and historical tra-

dition, naturally reflects such enduring differences.

One danger, though, is that states that are weak in both economic growth and environmental protection are particularly vulnerable to a funding squeeze that may turn out to be an important political dynamic during the next 10 years—the prospect of increasing demands for environmental protection that no one is willing or able to pay for. Many of the least prosperous states depend most heavily on federal funds to finance environmental protection at a time when such funds are increasingly scarce. And their budgets are likely to be more heavily burdened by demands like welfare and Medicaid and less easily expandable by tax increases or borrowing.

None of this is an argument for economic determinism, however. State economies are constantly changing as markets change, and experience has shown that political will and fortuitous circumstances can overcome obstacles to growth. Booming high-tech industries and tourism made the Rocky Mountain states, traditionally dependent on mining, timber, and agriculture, the fastest-growing region of the country in the early 1990s. And the recent opening of the \$11 million Jack Nicklaus-designed Old Works Golf Course in Anaconda, Montana, built atop a Superfund site, is not an isolated event.

WHAT TO DO?

Giving up on the simplistic theme of a race to the bottom among states to minimize environmental protection opens the way for considering harder questions. How much flexibility should states have to make choices about environmental measures? How can national priorities not in the interest of any one state best be advanced? How should chronic inequities among states be dealt with? A number of initiatives already under way suggest partial answers.

Variations on national themes. Setting clear national goals and giving states as much flexibility as possible in how to reach them out is the best way to medi-

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ate between national priorities and state differences. Supplementing standards with wider use of market incentives, negotiated solutions, and business self-monitoring can broaden local choices while respecting national priorities. The federal government should concentrate oversight wherever states are weakest, as the National Academy of Public Administration has suggested. And as information improves, state progress should be judged by environmental conditions, not by numbers of inspections and permits. All this is, of course, much easier said than done. After 30 years of efforts and billions of dollars spent, the United States does not yet have a reliable system of measuring trends in environmental conditions that could be a basis for setting national goals and marking progress toward them.

Information as regulation. Requiring that the public receive detailed information about environmental consequences can create incentives for business and governments to limit pollution, particularly if the consequences directly affect those receiving the information and if facts are accompanied by objective interpretation. Using “Surf Your Watershed,” the newest EPA Internet site, for example, anyone who enters a zip code can now learn about pollution sources, water quality, and drinking water sources. And the 1996 Amendments to the Safe Drinking Water Act, passed by the 104th Congress after two years of acrimony, require local water systems to notify customers once a year about bacteria and chemicals in tap water as one way of encouraging careful monitoring. These information requirements follow the example of the Toxic Release Inventory, a provision added to federal law in 1986 and recently expanded, which requires companies to report on their discharges of toxic substances.

Regional cooperation. The possible benefits of regional cooperation have received too little attention in a political system that emphasizes national and

state authority. Many environmental problems are inherently regional in scope, rather than national or local. We need to understand better why some attempts at regional cooperation succeed and others fail.

Creative financing. Voters who have effectively capped state revenues by resisting tax increases remain willing to pay special fees for environmental services or projects that are viewed as needed investments, helping to alleviate the funding squeeze, especially for the least prosperous states. Three-quarters of state and local waste disposal programs are financed by special fees, a proportion that has increased rapidly in the 1990s, according to a 1995 General Accounting Office report. Special fees also have disadvantages, of course. Linking revenue-raising to spending on particular activities can interfere with the agility of the political system in responding to changing public needs.

CHANGING TIMES

It would be a mistake to let the fears of the 1970s dominate action in the 2000s. The race to the bottom is a powerful idea that resonated with sudden changes in environmental requirements during the 1970s. It has little bearing on the challenges of the 1990s, when environmental costs are a relatively small portion of business expenses, state governments are more open to include environmental interests, and public understanding has improved. After nearly 30 years, environmental protection has been assimilated into the political system, where it will continue to evolve in thousands of separate national, state, local, and private actions. The success of those actions depends in part on our ability to adapt our ideas about how governments and businesses work to changing circumstances. In a time of scarce national resources and continuing disparities among states that are successful in economic growth and environmental protection and those that are less successful at both, our attention should now turn from the race to the bottom to the race to the bottom line. ■

Information & the Securities Markets

Massive technological advances, including the increasingly widespread acceptance of the Internet, are revolutionizing U.S. financial markets. Information flows are becoming seamless and borderless, instantaneous and almost costless. The swift changes so far and the still more rapid changes ahead offer opportunities for new value-added services, for new competitors, and for new forms of competition. They also underline the need for new thinking about regulating the nation's financial markets.

BY STEVEN M. H. WALLMAN

TECHNOLOGY AND THE SECURITIES MARKETS

New information technology has already transformed the securities markets. Order handling has largely been automated by mid-size and larger firms. Mutual funds are using the Internet to communicate with investors and to offer and distribute shares. Corporate issuers, large and small, conduct offerings on the Internet. Investors are starting to bypass traditional exchanges and dealer-based trading systems, using electronic networks to deal directly with each other at lower cost. Retail customers are trading stock on-line rather than calling or visiting a live broker. Certain small issuers have used the Internet to establish secondary trading markets for otherwise fairly illiquid stock without the benefit of the usual market intermediaries.

In the decade ahead, the continued growth of the Internet and its successors will present even greater opportunities for expansion and innovation in financial services, especially as consumers become more wired and more comfortable with electronic communications technologies and as security and

confidentiality issues are resolved. The effects will be felt throughout the financial sector. And as the marketplace adapts to new technology, so must regulation.

Information Access and Analysis. Companies conveying more information about themselves through the Internet will level the information playing field between individual investors and institutional investors. Eventually, relatively instantaneous access to portions of management information systems will permit investors to analyze raw financial information as soon as it becomes available—information now aggregated, at great cost, into quarterly and annual financial statements. Improved telecommunications technology, combined with better analytics, search technology, and intelligent (or “smart”) agent technology, will allow the market better to learn, absorb, and act on information, leading to more precise pricing of and innovative transacting in securities. Ultimately the perceived information risk of an investment will decline and, consequently, so will the corresponding cost of capital.

Corporate Governance. Electronic annual meetings will supplement and then replace “physical” ones. On-line voting will lead to more shareholder voting. Eventually, annual meetings may disappear altogether. Investors will use the equivalent of “chat rooms” to discuss company business. Shareholder activism will be energized. When a company needs improve-

Steven M. H. Wallman, a former commissioner at the Securities and Exchange Commission, is a nonresident senior fellow at Brookings.

Technology

The Challenge for Regulators

ment, shareholders will be able to use “voice”— corporate governance to enhance shareholder value—in real time, just as they use “exit”—selling their shares—today.

The Role of Intermediaries. Intermediaries who provide primarily communications without otherwise adding value (such as through analysis) will be replaced, sometimes by new intermediaries and new types of intermediation, and sometimes just by the technology itself. Offerings will be conducted electronically without masses of salespeople working for underwriters. Traditional exchanges and broker-dealers will transform themselves and provide new services.

Software providing “expert” financial planning advice for investors will eventually surpass in quality that provided by many human financial planners. Smart agents will compile an investor’s portfolio over the Internet, executing trades with increasingly less participation by the investor, providing convenience, speed, and diversification at low cost. New intermediaries will create the software and the means to run, sell, and promote it, as well as certify, rate, and rank it. As more investors use such technology, mutual funds and investment advisers will shift to add value in other ways.

Clearance and Settlement; Market Structure. Today’s three-day settlement time for securities will eventually become instantaneous, thereby removing the risk of default on trades. In the paperless world created by the new technology, shares would be held in book-entry form, just as mutual fund shares are today, with ownership transfers reflected just in the depository’s computer records. Improved fund transfer technology, electronic banking, and electronic cash will allow investors to pay for purchases and be credited for sales immediately. To the extent still necessary, then, credit card companies or companies like them will assume the guarantee function of clearing-houses by guaranteeing payment for securities purchases.

New trading systems custom-designed for different investor needs—boutique exchanges—will gain in acceptance. Ulti-

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mately, an investor will be able to choose from a world of competing marketplaces, domestic and international, with each market catering to the varying preferences of investors, whether immediacy of execution, or best price, or least market impact, or different type of trading system altogether. Finally, technology will continue to increase the globalization of the financial markets. The wall between competitors, built by geographic boundaries and time zones that once dictated and furthered nationalistic views toward commerce, will continue to fall because of better and lower-cost communications and analytics. Access to, and for, foreign capital markets and foreign users of capital through today’s technology will be increasingly simple.

PRESSURES FOR AND AGAINST CHANGE

All these innovations pose difficult questions for regulators. Should regulation be geared toward addressing fraud and manipulation or should technology itself be regulated, assuming it can be? For example, under the current regulatory scheme, “smart agent” software begins to resemble an investment adviser and the Internet begins to look like a trading market. And how should markets be defined where many markets (such as alternative trading mechanisms) no longer fit well within the definition of an “exchange” and often are regulated in some other manner? How will disintermediation—and the resulting loss of thousands of financial intermediaries acting as “eyes and ears” complementing governmental law enforcement efforts—affect the government’s ability to regulate effectively? And because the same innovations in information technology that foster growth and capital formation also provide a new venue for fraud and manipulation, how does one regulate to prevent abuse without curtailing innovation? (The case for law and regulation is too strong and obvious to suggest a return to pure *caveat emptor*.)

Historically, regulators have relied on a detailed, “com-

mand and control” approach to regulation to protect the public. But while that approach helps prevent abuse, it also slows the spread of innovation as new ideas languish awaiting regulatory approval. Still, notwithstanding the technology-induced need for a change in regulatory approach, the environment that fosters a command and control approach persists.

For example, industry, investors, the press, and Congress often ask regulators to address some specific issue or matter. Instead of rethinking existing requirements, regulators change them just enough to compensate for the new development. Consequently, the next change in technology requires a new modification to the rules just adopted.

In addition, regulatory agencies are usually scored by Congress or the press on the number of statements issued, rules affected, exams conducted, letters sent, or cases brought. Traditionally, the sign of an active and vibrant agency is a constant churning of activity. Many small steps count for far more than one giant step.

Sound-bite accountability also exerts a bias toward command and control, incremental regulation. Criticism is leveled at regulators far more often for failing to protect someone who becomes hurt than for failing to nurture something new or experimental that might—although no one is sure—have led to a better world. Consequently, regulators opt for specific and detailed rules that constrain behavior and channel activities to what is known and safe.

Moreover, as they have always done, regulators tend to look for standards they can efficiently inspect for and enforce—just as those who are regulated demand specific and detailed guidance. The search for certainty, both by those who have to enforce the law and by those who have to abide by it, encourages detailed regulation, not pronouncements of fundamental concepts that allow markets to develop on their own.

Finally, there are vested interests. Those market participants who are most successful under the current system often resist changes to it. Their loud voices become a force for the regulatory status quo.

Despite these understandable pressures for its continuance, incremental, command and control regulation can go terribly awry in a market whose fundamentals are changing rapidly. Unless regulators step back and look at these fundamentals, they can fail to see that the once-solid foundation on which they are building has been made unstable by shifting sands beneath it and that each small change they make is adding weight to an increasingly shaky structure.

NEEDED: REGULATORY FLEXIBILITY

The rapid pace of innovation today demands a bolder, more flexible approach to regulation. Command and control regulation must give way to regulation that is more “goal-oriented,” with regulators articulating broad goals and allowing market participants to determine how best to satisfy them. In 1995, for example, the Securities and Exchange Commission used a goal-oriented approach to resolve the question of

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whether corporations could use electronic communications to satisfy the federal securities laws. Given the advantages afforded by the electronic media, the SEC determined that the goal should be to encourage electronic delivery of information. The SEC could have taken the traditional command and control approach that would have dictated specific formats, along with multiple conditions, that alone would have satisfied the regulation. That way both regulators and the regulated community would know exactly what would be permitted and what would not. It would certainly have made for easier monitoring by regulators. But it would also have allowed little flexibility for accommodating further developments or advances in technology.

So instead the SEC focused on two regulatory goals—whether an electronic communication provided investors with “notice” of and “access” to information similar to traditional paper delivery of information. Market participants themselves were left to find ways to satisfy the two concepts and, therefore, the regulation. As a result, technological innovations can now be used as soon as created without first having to be approved by regulators. The response to the SEC experiment has been overwhelmingly favorable.

Such goal-oriented regulation, however, requires a wholesale change in the way regulatory agencies approach their mission, as well as in the way lawmakers write laws. It takes creativity and a good deal more work than writing command and control prescriptions. It takes regulators who are highly trained because ensuring compliance in such a system takes far more skill. It also takes some faith. We have to be willing to believe that the future holds worthwhile innovations as well as potential problems and issues. And we have to be willing to believe that allowing innovation without dictates from regulators as to what it must look like is ultimately better for U.S. financial markets.

A NEW MODEL OF FINANCIAL SERVICES REGULATION

Technology is also hastening a convergence among financial products and services and among financial services providers: a blurring of the lines between banks, securities firms, insurance companies, and futures merchants, and their products that requires yet another change in perspective for financial regulators. Agencies accustomed to competing with each other for regulatory turf must begin cooperating, and agencies accustomed to championing the industry they have traditionally regulated when inter-industry battles loom must instead work more to determine the best results for the financial services sector as a whole.

The traditional debate associated with convergence is whether the focus of regulation should shift from “entity regulation” to “functional regulation.” Providers of financial services historically have been regulated based on what they *are*—“banks” are regulated by various banking regulators; “securities firms” by the SEC and state securities administrators; the “futures” industry by the Commodity Futures Trading Com-

mission; and “insurance companies” by state insurance commissions. For many years, the four entities had little to no product overlap, and each entity was easily identified by the products it sold. Life was simple.

Today, because of competition and technological change, the entities sell products outside their traditional areas. In response, many reform advocates have pushed for “functional regulation,” where the activities relating to each specific product sold by an entity would be regulated by the agency with expertise in that product.

But as technology further melds the traditionally distinct financial products and services, distinctions based on product definitions—on whether something is or is not a security, a banking product, an insurance product, or a futures product—are becoming difficult to apply. Indeed, some financial products are increasingly viewed as near-perfect substitutes for others, and other products, such as variable universal life accounts and customized derivatives, blend some of the traditional products. In sum, both entity and functional regulation are becoming antiquated.

We need to step back then and remember why financial regulators regulate in the first place—in other words, we need to identify the goals of financial regulation—and reorganize our financial services regulatory structure accordingly.

Financial regulation has four obvious goals: protecting financial consumers and investors, controlling systemic risk, protecting against insolvency that places at risk federal insurance (taxpayer) or, in a different context, customer funds, and ensuring the integrity, efficiency, and competitiveness of markets. Under a system focused on satisfying these goals, one could conceive of a regulator like the Federal Reserve having authority over systemic risk issues, regardless of whether they stem from, for example, banks or securities firms. Similarly, an agency such as the SEC would focus on investor or consumer protection in connection with the sale of any financial service or product regardless of who is doing the selling or what product is being sold. The markets—equity as well as futures and commodities—would be regulated by an agency with a focus on market structure and competition theory (like the CFTC and some elements of the SEC), and agencies like the Federal Deposit Insurance Corporation or the Office of the Comptroller of the Currency would have jurisdiction over individual solvency issues, whether posed by banks, brokers, insurers, or futures merchants. Such a regulatory structure (which could be further simplified by combining some of the jurisdictions and agencies) could be effective over the long run and better able to adjust to technological advancements and competitive pressures. It would satisfy the four goals of financial regulation better, more efficiently, with less duplication, with more focused expertise, and at less cost than the existing system. It also would foster competition as all products and services could compete generally as “financial services.” Countries like the United Kingdom and Australia are already moving toward similar systems. If our financial services sector is to remain the best in the world, it will have to evolve something along these lines, notwithstanding such

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political issues as the need to reorient congressional committees and the need to encourage industries to accept more competitors on a larger playing field.

SOVEREIGN REGULATION

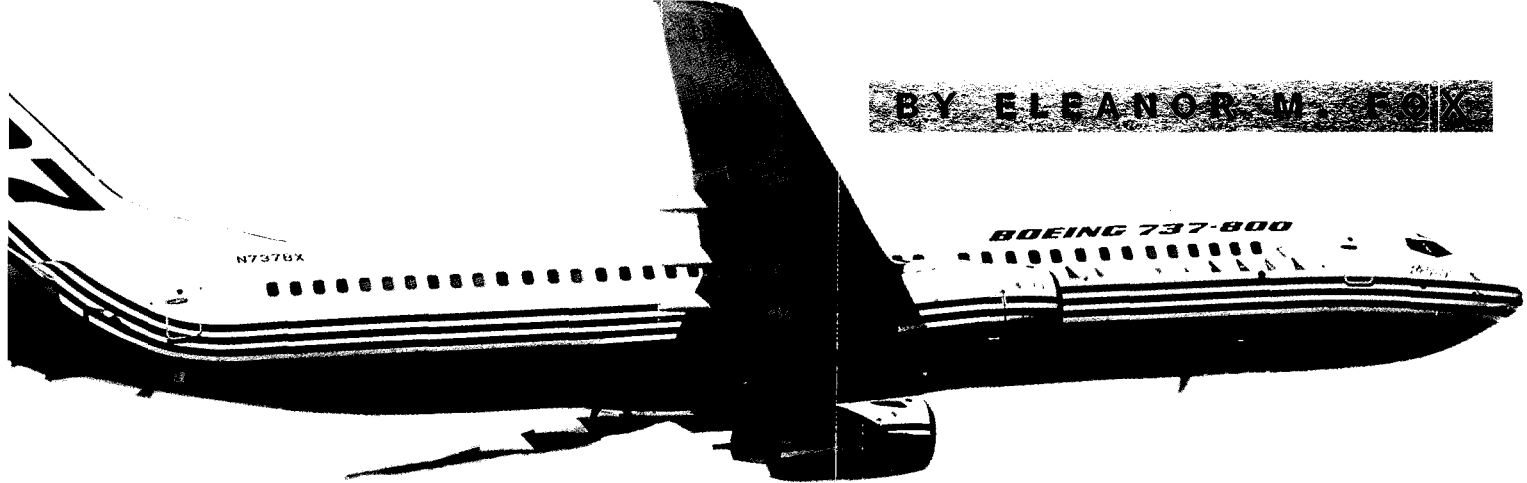
Yet another technology-related issue is how national regulation can continue in a global, electronic market. National governments have traditionally based their right to regulate on their sovereign right to do so within their borders—a right enabled by control over physical geography as well as by reasonably good controls over information flows. With the advent of new communications technologies like the Internet, control over information flows is increasingly tenuous.

The decline of territorial regulation raises other issues as well. For example, if a hypothetical exchange in Frankfurt posted quotes on the Internet for securities tradable by anyone anywhere in the world, how, and to what standard, would we in the United States regulate that exchange, especially if the home country thought their regulations were better than ours—just as we thought ours were better than theirs? And what do we do when, in the not distant future, someone sitting at a PC in Iowa wants to use cybercash to place funds in an account in Germany to buy securities trading on our hypothetical Frankfurt exchange or, perhaps even more likely, to trade globally securities on an exchange based solely in cyberspace, or not even on an exchange that is “organized” in any way we think of “organization” at the moment, but using smart agents that interact with other smart agents over the Internet?

Some have argued that although enhanced international coordination is a step in the right direction, it is an interim step on the way to what is really needed—a single international regulator for global financial markets. I doubt this goal will be realized any time soon. I would also argue that the existence of multiple regulators of international financial services having different perspectives and regulatory philosophies can be quite advantageous. For one thing, it reduces the likelihood that innovation will be stifled by a single, stodgy regulator. Sometimes, regulatory arbitrage has its benefits. Nevertheless, in today’s increasingly technology-linked world, enhanced international (and domestic) communication and cooperation among regulators is highly desirable, and more international coordination—especially to reduce further disparities that burden international commerce—is clearly required.

TOWARD A NEW FINANCIAL FUTURE

Today’s innovations herald a new financial world that, if allowed to develop, will provide tremendous advantages to all consumers of financial services. The challenge is to ensure that traditional regulation, grounded in a very different world, does not damage the emerging new one. I am cautiously optimistic. ■



BY ELEANOR M. FOX

Antitrust Regulation Across

THE UNITED STATES OF BOEING VERSUS

There was a certain irony when President Clinton threatened in July to go to the World Trade Organization if the European Union moved against Boeing's acquisition of McDonnell Douglas. ♦ "I'm concerned about what appears to be the reasons for the objection to the Boeing-McDonnell Douglas merger by the European Union," the president said, "and we have some options ourselves when actions are taken in this regard." The president was apparently referring to retaliatory trade sanctions against Europe, such as putting U.S. tariffs on European planes.

There was a brisk run up to the brink. High U.S. officials, up to and including the president, called or met with high officials in Europe to force a retreat. At the eleventh hour the Europeans did back down (or did they?). They let the merger proceed, but on two important conditions: Boeing would give up exclusivity on long-term supply deals, and Boeing would license to its competitors—that is, Airbus—McDonnell technology developed with U.S. government funding.

Just another trade case with a fairly happy ending? So the press and popular view would have it. Indeed, in the popular view this was a festering trade war triggered by European Competition Commissioner Karel van Miert, who was deter-

mined to protect Europe's subsidized Airbus from the competition that would be waged by a stronger Boeing. Europe took the first shot by threatening to ground the merger. In the name of its honor, its standing, and its economy, the United States had to fight back.

But wait a minute. Is something wrong with this picture? Is this not the merger of two of the last three firms in the highly concentrated commercial jet aircraft market? Is this not the administration that has threatened to sue Japanese glass makers for keeping American exporters out of Japan; that has sued two Swiss companies for merging in Switzerland; and that has (though I should not say it in the same breath) signed into law the Helms-Burton bill that penalizes foreign countries engaging in business in Cuba? Is this the administration that has temporized with the European Union's proposal for interna-

Eleanor M. Fox is Walter Derenberg Professor of Trade Regulation at New York University School of Law.

COURTESY BOEING



National Borders

THE EUROPEAN UNION OF AIRBUS

tionalizing antitrust on grounds that antitrust issues do not belong in the WTO, lest U.S. sovereignty get compromised? Is Boeing-McDonnell Douglas not an antitrust case, or has antitrust gone the way of politics?

In the aftermath, few Americans or Europeans believe that the Boeing affair was anything other than political. Most Americans believe the skirmish was a game of the Europeans to protect their champion Airbus. Most Europeans believe it was a game of the Americans to protect their champion Boeing.

Can it be that Boeing-McDonnell Douglas was a serious antitrust case dealt with in good faith on the merits by the expert agencies on both sides of the Atlantic and that the problem was one not of offensive intrusions meriting retaliation but of slightly divergent law in need of sympathetic links? Yes, it can be; and that is my thesis.

It is worth comparing the law of the United States with the law of the European Community, examining the divergences, and asking how Boeing-McDonnell Douglas might have been an antitrust case, start to finish, rather than a trade war.

TWO SETS OF LAWS

The U.S. and EU authorities reached different conclusions on the competitive effect of the merger. Why? Cynics find it obvious. The Federal Trade Commission's allowing the merger promoted the U.S. champion, and the European Community's challenging the merger promoted the Euro-

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pean champion. But this simple, obvious answer is almost surely wrong. Each set of experts appeared to apply the law on the merits.

This was possible both because there was an arguable question of fact and because of differences in the law.

The question of fact involved a prediction: was McDonnell Douglas still a competitive force in commercial jets? Would it ever again, on its own or with a new parent, be able to make and sell fleets of jets to the commercial airlines?

The FCC answered no. It was apparently unable to uncover or discover a willing purchaser for the commercial jet assets of McDonnell Douglas, and McDonnell Douglas, on its own, had no prospects of making and selling next-generation fleets. The European Commission apparently disagreed as to McDonnell Douglas's effect in the marketplace—as did one of the five commissioners of the FTC. The divergence of opinion was not suspect; reasonable people could differ.

When the FTC found that Douglas (the commercial aircraft division) was competitively insignificant, this meant the end of the U.S. inquiry. But in Europe the Commission had another string to its bow, because of the different tilt to its law.

U.S. merger law is consumer oriented. The inquiry is whether the merger will make consumers worse off, as by raising the price of jets to the airlines. If McDonnell Douglas was not a competitive force to be reckoned with, there was no antitrust problem.

COURTESY AIRBUS INDUSTRIE

EC law is concerned not only with consumers but also with unfair competitive advantages of dominant firms. Thus, not very far from the prospects for Douglas.

The cases are eclectic and contain hidden tensions. In some cases, where no competitor is threatened by a merger, the decision may focus on efficient market competition and consumer impact. In others, where competitors may be disadvantaged, the decision may postulate a predatory scenario with the prospect that the dominant firm will squeeze out its competitors and ultimately charge monopoly prices to consumers.

So it was with a case called *de Havilland*, which is cited by Europeans as authority for *Boeing*. ATR, a joint venture owned half by France and half by Italy, sought to buy Canadian *de Havilland* from its parent, Boeing. The merging

Douglas problem. One view is the antitrust perspective. The other is the national trade policy perspective.

The Boeing affair unfolded from the national trade vantage. Here is how it looks from the antitrust perspective.

First, we accord each agency the presumption of dispassionate application of the rule of law, unless proved otherwise.

So doing, we observe one authority has examined a merger and closed its investigation. (This act, incidentally, has no legal consequences. If, for example, the airlines believed that the merger was power-creating, they could and still can sue in U.S. courts.) The other authority has identified an antitrust problem under its law, and the merging parties have agreed to a solution that is satisfactory to that authority. A routine, colorless tale, this, much less riveting than the drama of a trade showdown.

The antitrust view is also the liberal trade policy perspective. That is so because the liberal point of view accepts the divergences of systems of law and tries, in the event of a collision, to find linking or sympathetic solutions.

From the antitrust and liberal point of view, one would recognize the problem as an international (not national) one and would give deference to the autonomy of states to

intervene against effects in their territory. Only in the event of a true conflict would there be need for a higher principle.

Some might argue that there is always a conflict when one nation's law is permissive and the other nation's law is proscriptive and both laws apply to the same transaction. A tension, yes; but not a conflict requiring one nation to abstain from using its law to protect its citizens from harm.

To be sure, there are costs to tolerance of diversity. Unless and until (if ever) there is a world law for international transactions, this is a cost we choose to bear.

Nonetheless, there are principles that can make nations' laws more sympathetic with one another, conferring on them aspects of open architecture and minimizing unnecessary costs of divergence. For example, nations could adopt the following four rules for transactions that could inflict antitrust harms across national borders.

1. Nations should apply their antitrust laws without discrimination.
2. Nations should not allow "national champion" interests to trump competition interests.
3. If nations pursue noncompetition objectives in antitrust cases, such as national security or a clean environment, they should do so transparently.
4. Political officials should neither provoke nor threaten trade retaliation against nations that have credibly applied their antitrust laws.

Politicians should leave antitrust to the experts. ■

Can it be that the Boeing affair was a serious antitrust case dealt with in good faith on the merits by the expert agencies on both sides of the Atlantic?

firms made commuter aircraft. *De Havilland* was in poor financial condition and needed a subsidy from Canada to survive. Canada welcomed the acquisition, and Canadian antitrust authorities cleared it. But the European Commission enjoined the deal because the dominant joint venture gained a fuller line of commuter aircraft, which would so disadvantage the competitors (the Commission said) that they would be squeezed from the market, to the ultimate harm of consumers.

The parallels to Boeing-McDonnell Douglas are striking. Moreover, in winter and spring Boeing entered 20-year exclusive contracts with three big airlines. To the FTC, these contracts were a separate matter from the merger, though they could be anticompetitive since they placed Airbus out of 11 percent of the market. To the EC, these contracts were an integral matter, since Boeing's already dominant market share would increase as a result of the merger, and the effect of the fencing out—the unfair competitive advantage—was accordingly magnified.

In the EU, Boeing-McDonnell Douglas may have been an easy antitrust case. And just because Airbus was a European favorite did not mean that the merger was not anticompetitive.

AVOIDING THE NEXT TRADE WAR

There are two ways to look at the Boeing-McDonnell



Social Regulations

As Trade Barriers

How Regulatory Reform Can Also Help Liberalize Trade

BY DAVID VOGEL

As U.S. regulatory reformers scrutinize the costs and benefits of federal regulations, they should also heed the regulation-related complaints of unfair trade practices from America's trading partners. For just as many U.S. health, safety, and environmental regulations impose substantial costs on American industry without yielding significant gain to society, some also disproportionately burden foreign producers seeking to do business here.

Criticisms of U.S. regulations by foreign firms are not always well founded. Just because a regulation imposes undue strains on importers does not automatically make it protectionist. But as a brief review of two important U.S. social regulations—fuel economy standards and rules for reformulated gasoline—will show, the regulatory burdens imposed on domestic firms are often closely connected to the emergence of new nontariff trade barriers. In cases such as these, trade liberalization and regulatory reform can be mutually reinforcing.

David Vogel is professor at the Haas School of Business at the University of California at Berkeley. This article is adapted from "Trouble for Us and Trouble for Them" in Comparative Disadvantages? Social Regulations and the Global Economy, edited by Pietro S. Nivola (Brookings, 1997).

U.S. FUEL ECONOMY STANDARDS

When Congress faced the challenge of formulating a long-term plan to reduce the nation's use of oil during the early 1970s, federal price controls on fuel were encouraging excessive consumption. Nowhere was this more apparent than in automotive fuel use, which accounted for 25 percent of American energy demand and the dominant share of domestic petroleum consumption. But fearful of a political backlash from ending price controls—let alone adding to the price with a new fuel tax, the policy



H. ARMSTRONG ROBERTS

adopted by virtually all other advanced nations—Congress shifted the burden of conservation onto motor vehicle manufacturers. It established fuel economy standards for all passenger vehicles sold in the United States. Beginning in the 1978 model year, the average fuel economy standard for all cars produced by each company was set at 18 miles per gallon. (Since 1990 the requirement for passenger cars has been 27.5.)

But the corporate average fuel economy (CAFE) standards are a dubious means of conserving energy. Their biggest shortcoming is that they focus the entire effort to reduce fuel consumption at the point of vehicle purchase. Once a consumer has bought a relatively fuel-efficient vehicle, he or she has no further incentive to drive less, or more slowly, or carpool—all good ways to conserve energy. In fact, because a new vehicle gets better gas mileage, motorists are inclined to drive

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more. Between 1973 and 1994 the average cost of motoring an extra mile fell by one-third, driving up the use of vehicles and driving down—by between 10 percent and 30 percent—the potential fuel savings from CAFE.

Although nearly 20 years of CAFE standards have helped improve overall fuel efficiency in the United States, a gas tax would have been much more efficient. According to Robert A. Leone and Thomas W. Parkinson, a “gasoline tax required to match CAFE’s conservation effect would have reduced pro-

As the history of the CAFE and reformulated gasoline rules shows, regulations deemed abrasive by U.S. trading partners can also turn out to be questionable as domestic policies.

ducer and consumer welfare by 8 cents a gallon saved while the regulatory alternative actually reduced welfare by around 60 cents a gallon saved.” Pietro Nivola and Robert Crandall estimate that a tax of (at most) 25 cents a gallon beginning in 1986 would have yielded as much, if not more, oil conservation as was achieved by CAFE through 1992.

Meanwhile, total fuel usage by all U.S. motor vehicles grew by 50 percent between 1970 and 1988. Average motor fuel consumption per vehicle in the United States has remained twice as high as in Europe and Japan. U.S. gas consumption reached a record 7.79 million barrels a day in 1995.

FUEL STANDARDS AND TRADE DISPUTES

Although CAFE may not have cut the U.S. use of oil, it *has* improved the competitive position of the American auto

industry by handicapping European makers of luxury cars. Nearly all the vehicles turned out by Jaguar, BMW, Volvo, Saab, Mercedes Benz, Rolls-Royce, and Porsche are high-end products with relatively low mileage per gallon. Unlike their U.S. and Japanese counterparts, these automakers have no smaller, more fuel efficient vehicles to bring up their corporate average fuel economy. In 1991, although the European manufacturers’ cars accounted for only 4 percent of U.S. sales, they paid 100 percent of CAFE penalties. Indeed, in the 20-year history of these regulations, these auto makers are the only companies who have ever paid a CAFE penalty. And the penalties, amounting to \$5 for every tenth of a mile per gallon that their fleet falls below 27.5, multiplied by the number of automobiles sold in the United States, have been substantial. Between 1985 and 1989 BMW paid CAFE penalties totaling \$32 million, Mercedes-Benz \$85 million, and Jaguar \$27 million.

In 1993 the European Union filed a complaint with GATT alleging that American CAFE rules constituted a nontariff barrier. In the fall of 1994, a dispute settlement panel found the CAFE fleet-averaging procedure did not violate the GATT, primarily on the grounds that it did contribute toward achieving a legitimate regulatory objective, namely improving fuel efficiency. Although it agreed with the EU that the U.S. policy objective could be achieved in ways that were less restrictive of trade, especially by increasing the U.S. gas tax, it declined to hold the U.S. regulation to the “least trade restrictive” standard.

Although American environmental groups and the Clinton administration expressed delight and relief at the outcome of the dispute, the victory was pyrrhic at best. For the least trade-restrictive policy option is also the most sensible for American energy policy. A serious gasoline tax would not only lower fuel consumption at a fraction of CAFE’s social cost, but would also avoid any discrimination among producers of European, Japanese, and American luxury vehicles. More

important, by truly reducing the consumption of oil, it would curb American dependence on foreign energy sources—a more useful policy objective than reducing American dependence on foreign cars.

U.S. CLEAN FUEL STANDARDS

A major focus of the federal government's effort to improve air quality over the past quarter century has been reducing automotive emissions. During the 1970s regulatory efforts targeted changes in engine technology. In the late 1980s, as Congress began another major rewrite of the Clean Air Act, Washington began contemplating changes in the composition and content of motor fuels as a way to further reduce automobile emissions. Following considerable controversy, the 1990 Clean Air Act Amendments set new standards for gasoline content, a change aimed at improving air quality for the nearly 89 million Americans living in so-called nonattainment areas—cities where air quality does not meet federal standards for ozone concentration.

The law defines nonattainment strictly and precisely: if the fourth-highest daily one-hour reading recorded on any monitor during the preceding three years shows an ozone concentration greater than 0.12 part per million, the area is not in compliance with federal ozone standards. If compliance were instead measured by the average reading, the number of nonattainment areas would fall significantly. The average readings in most nonattainment areas exceed the federal standard in less than 1 percent of the hours monitored. In fact, with the exception of Los Angeles, almost all nonattainment areas meet federal standards more than 99.4 percent of the time. Moreover, most ozone comes from emissions from pre-1983 cars, which are gradually being phased out. In addition, the precise nature and extent of the health effects of prolonged exposure to ozone have yet to be demonstrated, while the costs of reducing VOC (volatile organic compounds) emissions that produce ozone are

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extremely high. According to the Office of Technology Assessment, reducing VOC emissions by 35 percent from their 1990 levels will cost between \$6.6 billion and \$10 billion a year by 2004.

GASOLINE STANDARDS AS TRADE BARRIERS

On December 15, 1993, the EPA issued regulations implementing the reformulated gasoline provisions of the 1990 Clean Air Act. The rules required the sale of cleaner-burning gasoline in the nation's smoggiest cities beginning January 1, 1995. To avoid disrupting the fuel market and to provide refiners enough time to adjust their production, the EPA decided to issue a five-year interim standard rather than a fixed one. Between 1995 and 1997, refiners were required to reduce the amount of olefins (a chemical that leads to emissions of nitrogen oxide, which in turn contribute to ground-level concentrations of ozone). The reductions would be made on a percentage basis, using 1990 as the base year.

But though American refiners could use their actual 1990 production as their baseline, foreign refiners were required to measure their improvements not against their own production but against the U.S. average or statutory baseline. And to prevent refiners from dumping high-emission reformulated gas byproducts into conventional gasoline, all non-reformulated gasoline sold in the United States had to be at least as clean during 1995–97 as it was in 1990, with, again, the 1990 base calculated differently for foreign and domestic refiners.

The EPA recognized that this rule would make it harder for foreign refiners to sell their gasoline in the United States. EPA Assistant Administrator Mary Nichols told a Senate committee that she was “motivated by a desire to lean in the direction of doing something that would favor the competitiveness of U.S. petroleum companies vis-à-vis Venezuelan companies.” Publicly, however, the agency claimed that it would be impossible to hold for-

eign and domestic producers to the same standard because in 1990 few importers collected the data needed to set their own baselines.

Venezuela, a major supplier of imported gasoline to the United States, immediately filed a formal complaint with GATT, arguing that the rule violated GATT's national treatment clause by holding a like product to different standards depending on its country of origin. Not eager to risk losing a trade dispute in the midst of the Uruguay Round GATT negotiations, the Office of the U.S. Trade Representative pressured the EPA to modify its rule. Prudently, the office considered it “essential to try to make our country's environmental objectives and trade objectives compatible where possible.”

In response, the EPA proposed a corrective rule that would allow foreign refiners to establish their own baseline as long as they could supply it with the necessary data. In effect, the rule exempted Venezuela, because only its national oil company, *Petroleos de Venezuela S.A. (PDVSA)*, appeared to have the required data. At the same time, to ensure no significant deterioration in U.S. air quality, the new rule provided that any increase in the volume of gasoline imports from their 1990 levels would have to meet the statutory baseline.

The compromise outraged both environmentalists and the U.S. refining industry. EPA's amended rule appeared to confirm environmentalists' fears that trade liberalization would compromise domestic regulatory standards. And domestic refiners, having been forced by the 1990 Clean Air Act to invest billions of dollars in new technologies for refining gasoline, now wanted protection from less expensive gasoline imports. Industry representatives claimed that the EPA's decision created “uncertainty” about the government's standards for reformulated gasoline.

Led by Sun Oil, a major marketer and refiner in the Northeast, where virtually all Venezuelan gasoline is sold, a coalition including the National Petroleum Refiners Association, the American Petroleum Institute, and several major

American companies lobbied to have Congress overturn the EPA's revised rule. The effort, strongly supported by environmentalists, was effective. In August 1994 the Senate amended the EPA appropriations bill to prohibit the agency from implementing the new regulation. Later the House approved the change, and the EPA was forced to reinstate the original rule—one that did little to improve environmental quality while serving as a trade barrier.

THE WTO DISPUTE

Venezuela, of course, resubmitted its complaint, first with GATT and then with the newly established World Trade Organization, which convened its first dispute settlement panel to hear the case. Venezuela's financial stakes were considerable: PDVSA had already embarked on a \$1 billion refinery upgrading program, most of which was contracted to U.S. engineering and construction firms, to meet U.S. reformulated gasoline requirements and double its gasoline exports to the United States. Unless the rule was changed, exports to the United States would fall by 50,000 barrels a day, costing PDVSA \$150 million a year in sales through 1997.

The environmental stakes in the trade dispute ranged from modest to nonexistent. The average olefins content of Venezuelan gasoline is double that of the Clean Air Act baseline. According to a federal report, reformulated gas "produced to Venezuela's 1990 baseline would have as much as 13.9 percent greater NOx emissions than U.S. average RFG." This in turn could significantly increase ozone levels in the Northeast, where nitrous oxide triggers ozone formation.

Congressional testimony revealed, however, that 59 of 88 domestic refiners had olefin levels higher than the statutory baseline to which foreign refineries were being held. Only 16 domestic refiners were able to meet the parameters of the statutory baseline. Indeed, an internal EPA memo noted that "some domestic refiners have some individual gasoline baseline parameters

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that are as dirty or dirtier than PDVSA's," adding that the overall NOx increase from permitting PDVSA to use its 1990 baseline would be much less than 1 percent. Moreover, Venezuelan gasoline is comparatively clean in other respects. PDVSA's planning manager for refining emphasized, for example, that "Venezuela exports only unleaded regular gasoline to the U.S. and, when compared with U.S. regular gasoline with which it competes, it has the same or lower sulfur and olefins content."

The dispute over the health effects of Venezuelan gasoline appeared to have less to do with environmental protection than with the use of environmental rules to allocate market shares, internationally as well as domestically. Not surprisingly, PDVSA's demand that it be permitted to use its own baseline was strongly endorsed by the Society of Independent Gasoline Marketers of America, whose 250 members account for 20 percent of domestic motor fuel retail sales and depend on a diversity of supply sources to remain competitive with the fully integrated oil companies.

Only 3–7 percent of the gasoline used in the United States is imported, and of this about 20 percent, roughly 70,000 barrels a day, comes from Venezuela. But gasoline markets are regional, and foreign refiners have supplied about 16 percent of the gasoline sold on the East Coast and 20 percent of that sold in the Northeast. Restricting gasoline imports would curtail competition there, and consumers in the region would wind up paying considerably more for gasoline in return for little or no improvement in air quality.

On January 17, 1996, the WTO issued its ruling. Noting that the U.S. standard clearly accorded imported gasoline less favorable treatment, it asked whether the different treatment was necessary for the United States to achieve the legitimate objective of cleaner air—and concluded that it was not. The United States had not demon-

strated that its air quality would suffer if foreign refiners were allowed to use their individual baselines rather than the U.S. statutory average. Moreover, if doing so did result in adverse environmental impacts, the appropriate U.S. policy would be to tighten requirements slightly on both imported and domestic gasoline, not to hold them to different standards.

The United States appealed the decision to the WTO internal review board, which affirmed the panel's ruling the following April. On June 19, 1996, the Clinton administration announced it would propose changes in the application of clean air rules to imported gasoline to bring the United States into compliance.

BETTER FOR ALL

Many social regulations clearly make the American public better off, even though they may vex foreign firms. But as the history of the CAFE and reformulated gasoline rules shows, regulations deemed abrasive by U.S. trading partners can also turn out to be questionable as domestic policies. In both cases, the interests of the American public would have been better served had the United States chosen to accomplish its legitimate policy objectives by adopting the least trade-restrictive alternative. In both cases, the interests of foreign producers and of the American public actually complemented one another. Thus the complaints of America's trading partners about the discriminatory effects of some U.S. regulatory policies warrant serious reflection. Trade agreements can help improve domestic regulatory policies because they can highlight rent seeking that is masquerading as consumer or environmental protection. Just as U.S. efforts to pressure Japan to open its markets have frequently reinforced internal Japanese efforts to reform that country's economy, so might America's trading partners play an equally constructive role in reforming some U.S. regulatory practices. What may be good for them is sometimes also better for us. ■

旭化成	334	1727
サッポロ	83	106
アサヒ	2713	340
キリン	331	2668
宝酒造	302	2904
合同酒	3	507
カルビー	94	1072
中京カカ	1	42
三國カカ	32	7
ヤマト	2	361
ホー	8	11
日清	3	18
不二	16	202
キッコー	251	202
味の素	129	508
キューピー	8	372
ハウス	61	19
カゴメ	15	59
ニチレイ	49	803
加ト吉	10	225
ヨコレイ	3	37
東洋水	37	69
日清	54	102
ミヨシ	51	1952
グンゼ	179	638
川島織	31	564
東洋紡	156	2361
館紡	708	3434
ユニチカ	92	5679
富士紡	142	2137
クラボウ	119	3748
ダイワ	0	40
シキボウ	0	3
日東	318	1388
帝人	55	600
東邦	388	1291
三井	169	1943
クラレ	512	193
カネバ	264	1824
パルソン	1	77
戸森工	29	910
日本ナ	89	2163
裕助	0	525
フコク	28	204
三和	27	428
ナガイ	76	630
オワード	71	33
市田	51	348
レナウン	145	2002
JAL	204	388
東スタイル	11	162
デサント	188	505
デパン	42	772
東海	114	165

The "Big Bang"

An Ambivalent Japan Derregulates Its Financial Markets

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戸森工	29	910
日本ナ	89	2163
裕助	0	525
フコク	28	204
三和	27	428
ナガイ	76	630
オワード	71	33
市田	51	348
レナウン	145	2002
JAL	204	388
東スタイル	11	162
デサント	188	505
デパン	42	772
東海	114	165

BY EDWARD J. LINCOLN AND ROBERT E. LITAN

Regulatory reform is a hot issue in the United States, as other articles in these pages attest. Successes over the past several decades in deregulating transportation and financial services are being followed by new moves to make government social regulation more effective and to bring the costs and benefits of regulation into better balance. In this article, the authors look across the Pacific to assess a major regulatory reform ini-

In November 1996, Prime Minister Ryutaro Hashimoto, borrowing rhetoric from the 1980s deregulation of London's financial markets, called for a "Big Bang" deregulation of his country's financial markets to be completed by 2001. Japanese governments have trotted out various regulatory reform measures over the years, with mixed results at best. Is this time any different?

Certainly the fanfare surrounding the announcement of the Big Bang would lead one to believe the answer is "yes." Indeed, measured against the limited results of past Japanese deregulation initiatives, the new proposals are indeed ambitious and represent a welcome movement by Japan toward freer capital markets. But the ultimate impact of Japan's Big Bang will be limited by its place in a national economy that remains elsewhere highly regulated—and in a society that in many ways remains hostile to deregulation.

Edward J. Lincoln is a senior fellow in the Brookings Foreign Policy Studies program. Robert E. Litan is director of the Brookings Economic Studies program.

BACKGROUND

Until the late 1970s, Japan's financial markets were, like the rest of its economy, highly regulated. The overall financial system intentionally favored banks, the banking sector was finely segmented, banking and securities firms were strictly separated, virtually all interest rates were controlled by the government, foreign exchange was tightly controlled, and the variety of financial instruments of all kinds was limited and subject to approval by the Ministry of Finance. Monetary policy tended to operate through quantitative measures (varying the supply of central bank credit to the commercial banking system) rather than interest rate manipulation. And with interest rates set below market-clearing rates, the government was also in a position to influence commercial banks' allocation of credit to industry.

Changing economic conditions, however, were posing challenges to regulatory controls toward the end of the 1970s. Rapid increases in government deficits and government borrowing from the financial community to the low interest rates at which government debt was issued led to a gradual freeing of interest rates. This in turn led to in profitability among different kinds of banks led to lower barriers among the various segments of banking. Since the mid-1970s controls over foreign exchange have also been extensively eased.

But the pace of deregulation has been halting, and results have been mixed. Encouraged by the Ministry of Finance, large commercial banks moved into real estate in the 1980s but quickly engaged in imprudent lending. Their indiscretion helped feed the real estate and stock market speculation in the 1980s, and the collapse of those bubbles has left the banking sector saddled with enormous amounts of nonperforming loans and blighted reputations. At the end of the third quarter of 1993, nonperforming loans officially totaled 28 trillion yen or some \$230 billion. Private estimates run as high as \$700 billion (by way of comparison, all commercial and industrial bank loans made in the United States total just over \$800 billion).

Japanese financial institutions also used their new freedom to expand rapidly in world markets in the 1980s, only to discover that their highly protected history left them poorly equipped to compete. Able to gain market share through aggressive pricing of loans and other financial services, but unable to evaluate risk, they have been retreating from many of those markets in the 1990s. In the reverse direction, foreign financial institutions rushed into liberalized Japanese markets during the 1980s, only to be hamstrung by remaining regulations that kept transactions costs high and deprived them of many competitive advantages in the market.

THE NEW DEREGULATION AGENDA

Japanese government officials, distrustful of letting markets allocate credit in the economy, had been quite satisfied with the tightly controlled financial system of the 1950s through the 1970s. But the gradual deregulation of the past 20 years has changed that system irreversibly, and the insistence of some officials that further deregulation is necessary to yield a stable and efficient new regime led Prime Minister Hashimoto to promote the Big Bang reforms, which promise benefits both for Japanese consumers (individuals and businesses) and for foreign firms seeking business in Japan.

For example, further deregulation of foreign exchange rules—especially ending the monopoly of certain commercial banks over the foreign exchange business and liberalizing limits on individual investment overseas—will enable Japanese depositors who now earn as little as one-tenth of 1 percent interest on their yen accounts at Japanese banks to get much higher returns on foreign currencies (provided they are willing to accept the risk of depreciation of those currencies). The new rules should also widen opportunities for non-Japanese banks to compete for Japanese funds.

Securities market reforms—including deregulating brokerage commissions, easing rules concerning trading shares off-exchange and over-the-counter, easing rules on trading financial derivatives, and dropping the securities transactions tax—should spur competition, thus benefiting Japanese securities investors while broadening opportunities for firms (foreign and domestic) outside the “big four” Japanese securities houses. Insurance sector deregulation—permitting price competition, greater flexibility in product design, and removal of barriers between life and nonlife insurance companies—should bring similar benefits to insurance consumers and non-Japanese insurers seeking to expand business in the Japanese market.

By legalizing financial holding companies capable of owning banks, insurers, and securities firms (with some restrictions on size and scope), Japan will throw off the yoke of restrictions on cross-industry competition imposed by the United States after World War II. Subject to an important caveat spelled out below, this reform should give Japanese consumers the same benefits of “one-stop” financial shopping that European “universal banks” have provided their customers (and that some American financial institutions are seeking to emulate, pending further modernization of U.S. financial laws).

In principle, Japan will legalize “asset-backed securities,” such as the mortgage-backed securities that have revolutionized home finance and helped make housing more affordable in the United States.

By allowing Japanese pension funds greater investment

freedom—specifically, broader authority to purchase equities, domestic and foreign—the Big Bang will help ease the pressure on Japanese corporations to fund their pension plans with current earnings.

Potentially most important of all, Japan will replace its cumbersome and deliberately restrictive policy of licensing all new financial institutions. Instead, financial regulators will simply attest to the financial soundness and noncriminal backgrounds of those seeking to enter the financial business (much as U.S. regulators now do). Together with the planned decontrol of insurance and securities commissions, this reform should make it easier for foreign and domestic entrants to compete in the Japanese marketplace.

The list of potential reforms is considerably longer, but many of the items proposed are either minor or still quite vague. Deregulation of foreign exchange transactions, removal of the bank holding company ban, and decontrol of brokerage commissions all will begin in 1998. Other moves should follow over the next three years.

BIG BANG: SOME CAVEATS

For all its merits, Big Bang will still leave the Japanese financial system short of complete reform in important ways.

First, it is unclear whether Japanese financial institutions will shift their internal practices to meet the new challenges. Japanese corporations, both financial and nonfinancial, have strongly favored rotating individuals broadly through the organization rather than encouraging specialization. But complex financial markets require specialized expertise. Similarly, understanding the complexities of financial markets requires strong mathematical skills. But, as in Japan's economy generally, decisions in Japanese financial institutions are based to a large extent on personal relationships with clients (and internally with one's colleagues) rather than on careful quantitative analysis. These entrenched practices—at the core of what many Japanese believe is the essence of their brand of capitalism—are not easy to change. But no one is even talking about the need for such change.

Second, if markets are to operate on the basis of dispassionate risk analysis rather than personal relationships, markets and financial institutions need access to accurate and relevant information. Corporate annual reports in Japan convey relatively little that is useful, and official financial filings are little better. As with personnel practices, this problem is deeply imbedded in the fabric of Japanese society. Information does not flow as freely in Japan as in the United States, and it tends to run in channels characterized by close personal or corporate ties. Under the Big Bang, corporations are supposed to change their accounting practices from registering assets at purchase cost to current market value, but this is only one of many changes needed to provide markets with adequate information to evaluate risk and potential returns.

Third, the failure of the reform package to envision a marked reduction in “stable stockholding patterns” is yet another obstacle to change in nonfinancial corporate governance and behavior. The bulk of corporate equity in Japan continues to be held

by other corporations (both financial and nonfinancial) on a long-term basis to cement relationships or protect one another from hostile takeovers. As a result, corporate behavior does not respond to fluctuations in share prices, and the stock market plays little real role. Optimists believe that banks, permitted to own up to 5 percent of the equity of other corporations, will be forced to sell off these large holdings of shares if deregulation implies a more competitive market (creating an environment in which they cannot afford to hold shares for essentially uneconomic reasons). But it is far more likely that those shares, if actually sold, would be placed with other friendly corporations, with little change in the overall pattern. Thus the stock market will remain relegated to trading a minority of issued shares, with little real impact on corporate behavior or ownership control.

Fourth, legalizing holding companies may not be as revolutionary as some observers expect. While the change will allow financial institutions to enter fields of business previously denied them, the record of the banks in operating subsidiaries, especially the *jusen* real estate lending organizations that were at the center of the bad debt fiasco, is not encouraging. Optimists also believe that holding companies will give nonfinancial firms a way to acquire or expel business divisions in response to pressures to restructure themselves more efficiently. Without market discipline or an active merger and acquisition market, Japanese corporations have had a tendency to maintain poorly performing divisions. But underlying the lack of acquisitions and divestitures in Japan have been strong social constraints on personnel practices. A firm that acquires another has virtually no ability to downsize the workforce or greatly alter upper management, and there is no sign that this problem is changing. The new holding company format is therefore unlikely to cause a burst of effective corporate restructuring.

Fifth, all the talk about deregulation remains at odds with Japanese government behavior at the bargaining table. Insurance is being touted as a major part of the financial Big Bang, but the reforms came only after three years of often bitter negotiations between Japan and the United States. Without heavy American pressure, the internally generated Big Bang would have fallen far short on allowing price competition, product innovation, and new marketing techniques. Other areas of domestically generated deregulation are thus likely to be disappointing to foreign observers when the final rules are settled and implemented. For example, although the rhetoric of Big Bang has emphasized total decontrol of foreign exchange transactions, the Ministry of Finance already has announced (even before the new rules go into effect) new reporting requirements, designed to inhibit tax evasion, for anyone moving more than 2 million yen (about \$18,000) into or out of the country. These rules could have a chilling effect on transactions. If they do not, and if massive outflows of funds go from Japanese to foreign banks, the ministry would be likely to impose stiffer restrictions to slow the exodus so as not to precipitate a run on Japanese institutions.

Finally, to be fully effective, financial deregulation requires a population willing to take advantage of newly available financial instruments. But the Japanese public remains distinctively risk averse in its investment decisions, keeping a high share of

its savings in the form of bank accounts and insurance policies. It is not at all clear that they will jump at the chance to broaden their savings portfolios to include asset-backed securities, foreign mutual funds, derivatives, foreign bank accounts, and other investment opportunities. In the absence of an eager household sector, financial deregulation could leave the Japanese financial system under the continued domination of banks, which may end up as the primary holders of the new financial instruments. This was the story of corporate bond deregulation in the 1980s; as the bond market was gradually decontrolled and allowed to expand, the primary purchasers of corporate bonds were banks. In the end, little changed in the real flow of funds or in the way institutions handled information and made lending decisions.

UNFINISHED BUSINESS THE BANKING MESS

Sometimes the most important element of any policy initiative is what is not included. For the Big Bang, the missing element is a clear policy for supervising the nation's banks, whose real economic capital (as distinguished from the official reported capital figures) has been severely depleted by nonperforming loans. An honest accounting of the Japanese banking situation would probably reveal that numerous insolvent banks remain in business while many others have capital well below international standards. Failure to confront this huge problem undermines the Big Bang, creating a system filled with weak institutions could do little to encourage officials and politicians to push with vigor.

To be sure, it took U.S. policymakers own up to the mess in the 1930s. In the 1980s savings and loan crisis—during which problems only grew worse. But when regulators did begin in the late 1980s, they did so forthrightly, shutting down insolvent banks and thrifts and paying off their depositors, or, in other cases, providing some government funds to induce healthy institutions to take over the insolvent ones. Meanwhile, regulators forced weakly capitalized banks either to shrink or to obtain new capital. The process was painful and arguably delayed the recovery from the 1990–91 recession, but after it was over, the United States was left with one of the world's strongest banking systems.

Japan faces several hurdles to adopting the U.S. model to resolve its financial institution mess. On the political front, elected Japanese leaders and officials in the Ministry of Finance fear popular opposition to using public funds even to put insolvent institutions out of their misery. The bold action in November protecting deposits at Hokkaido Takushoku Bank, one of Japan's largest, is an encouraging sign. The critical ques-

tion now is whether the Japanese authorities will mount a larger bank cleanup program. A key impediment to doing so is that relatively few healthy Japanese banks are capable of taking over the many other weaker ones. In principle, this drawback could be overcome if Japan were to court foreign banks and financial institutions to bid for weak and insolvent Japanese banks. But foreign interest is limited by opaque Japanese accounting practices. With Japan's real estate market virtually frozen—by inefficient zoning rules, heavy transactions taxes combined with very light property taxation, inadequate ability to remove tenants, and other problems—and with few transactions taking place, it is hard for anyone, foreign or domestic, to know the true value of the real estate collateral that underpins most Japanese nonperforming loans.

Although no single change is likely, by itself, to lead to a cleanup of the Japanese banking situation, the government has no other choice except eventually to use public funds to solve the problem. As long as the banks remain weak, the overall Japanese economy will struggle to mount a healthy recovery. The Big Bang reforms desperately need a healthy economy to succeed.

Japanese policymakers can learn at least one negative lesson from the United States. In the 1930s, the United States placed asset investment restrictions for thrift institutions, most of which were insolvent at the time yet continued to operate because of deposit insurance. With incentives to gamble for resurrection, many thrifts abused the wider investment authority that was given and wasted billions in real estate deals. Facing a similar situation now with its banks, Japanese policymakers would be well advised to limit the ability of weak banks to affiliate with or be owned by nonbanking enterprises which could be used to run excessive risks in the hope that the profits from the gambles would be used to help their weak banking masters. To prevent such an outcome, the authorities should insist that only well capitalized banks—measured by the best accounting rules—be permitted to take advantage of the broader powers allowed under the new financial holding company legislation.

PERHAPS THE START OF SOMETHING BIG?

Japan's Big Bang is certainly bigger than previous reform efforts and thus should promise some significant changes in the country's financial system. Even with the caveats expressed above, the proposed changes are a positive development. But more sweeping reform remains to be implemented, while sizeable problems in the banking system continue to fester. Incompleteness of the current round of reforms will leave many inefficient or undesirable practices in place, and the banking mess may sap the strength of reform. Look for an even "Bigger Bang" sometime down the road. ■

A DEBATE ABOUT THE FUTURE OF BOSNIA

Turning the Bosnia Ceasefire into Peace



JON JONES/SYGMA

BY MICHAEL O'HANLON

Since they were signed in 1995, the Dayton accords have accomplished a great deal in Bosnia. Armed conflict has been stopped and further genocide and widespread ethnic cleansing prevented. Troop casualties in the NATO-led operation have been extremely low. Unemployment is down from 90 percent to 50 percent (though progress has been less notable in the Serb region). The military disadvantages that plagued the Muslims throughout three and a half years of war have been largely eliminated through the U.S.-led train-and-equip program as well as a regional arms control plan that has already led to the destruction of more than 4,000 heavy weapons. NATO forces have cooperated with Russian troops in pursuit of these common goals, giving real substance to their budding and critically important partnership.

Michael O'Hanlon is a fellow in the Brookings Foreign Policy Studies program. He is the author of the forthcoming study, The 1999 and 2000 Defense Budgets.

But for the current ceasefire to turn into lasting peace, the Dayton accords need a fundamental overhaul. Most important, their aspiration to achieve a truly reunified and multiethnic Bosnia must be recognized as unrealistic. A more workable goal would be to partition the Bosnian state into three distinct countries, each dominated by one of the three major ethnic groups. Even if partition is not adopted as formal policy, the goal of reversing ethnic cleansing should at least be dropped. The map of Bosnia should also be redrawn to give the Muslims more land. Making even this scaled-down plan work will be tough enough. For it to have a good chance of success, an outside force will need to stay in Bosnia well beyond the completion of the current mandate next June, and U.S. units will need to be a part of that force.

The Dayton accords are at war with themselves. They are both a plan for reunification and a plan for partition. The accords call for return of refugees and reintegration of the country at the local and national level, while also legitimizing separate armies and permanent lines of separation between them.

Growing out of this contradiction are three specific flaws. First, the call for refugees to return to their homes is infeasible and indeed dangerous—as Bosnians have themselves generally discovered when trying to return to their original communities. Second, Dayton's current map does not give the Muslims as much land as their share of population warrants, and the land it does allocate to them does not constitute a politically or economically viable entity. Finally, Dayton's ambitious approach to trying large numbers of indicted war criminals at the Hague risks a repeat of the Somalia tragedy—casualties suffered in manhunts that the U.S. public has not been prepared for and does not support.

Once a revised peace accord that redresses these flaws is developed, the Clinton administration should be able to overcome congressional pressure to bring home U.S. troops in June. It should, in fact, declare its intention to keep several thousand American troops in the region until at least the year 2000.

Defending Partition

Fixing Dayton will probably require something that, even if it is not called partition, largely amounts to it. Taking that position requires answering the arguments of those who oppose partition on principle—like Dayton's chief architect, Ambassador Richard Holbrooke, President Clinton's national security adviser Sandy Berger (most notably in a September speech at Georgetown University), and scholar Radha Kumar

writing recently in *Foreign Affairs* magazine.

Opponents of partition often argue that it would sanction ethnic cleansing. But what really sanctioned ethnic cleansing was the West's refusal to take action to prevent tens of thousands from being butchered and hundreds of thousands from being forcibly uprooted during the Balkan wars. Moreover, Dayton is not reversing ethnic cleansing: two years into the NATO presence in Bosnia, only a few percent of those displaced have returned to their original homes.

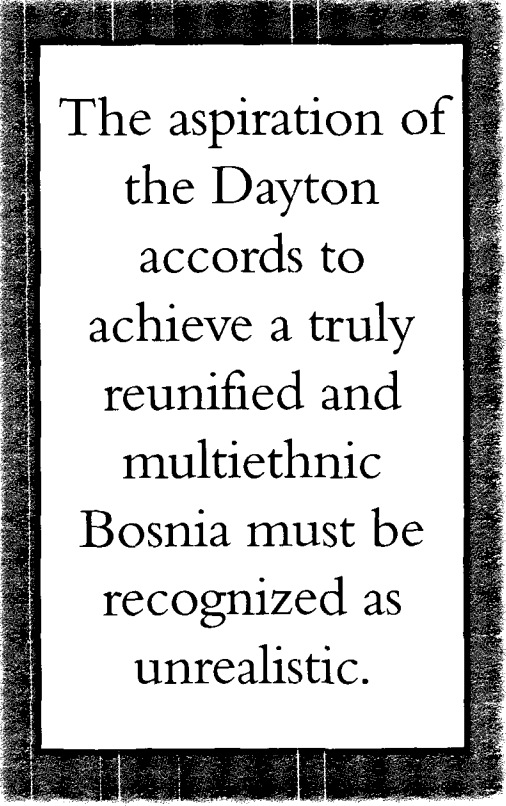
Mr. Berger recently claimed that allowing partition in Bosnia could create a dangerous precedent for other civil conflicts around the world, emboldening would-be secessionists to pursue their goals through force. But Berger's espousal of such a latter-day "domino effect" is unconvincing. After all, holding to the goal of a unified Bosnia has not deterred or ended numerous other civil wars going on in the world today.

At this point, the real issue is not how to wrestle with our guilty consciences but how to turn the Bosnia ceasefire into a genuine peace. Mr. Holbrooke has recently claimed in a *Washington Post* op-ed that an "imposed partition" would probably lead to resumed warfare. But U.S. Information Agency polls in Bosnia, to say nothing of realities on the ground, show powerful and widespread pressures for partition among Bosnians themselves. According to a USIA survey published last February, 85 percent of Bosnian Croats lack confidence in the Muslim-Croat Federation Army. Although about half of the Muslims are supportive of the tripartite presidency, roughly 80 percent of all Croats and 90 percent of Serbs have little faith in it and prefer independence or merger with Croatia and Serbia, respectively. Shockingly, comparable percentages continue to give

favorable ratings to their own respective indicted war criminals like Ratko Mladić. Since Dayton was signed, more Bosnians have left homes in regions where they were minorities than have returned to such regions. These trends make partition look like the home-grown solution to the conflict and a multiethnic Bosnia the externally imposed approach.

Also, partition can work. It has succeeded with the Czechs, Slovaks, and Slovenians. Some form of partition is also the preferred policy of the major parties to the Arab-Israeli and Indo-Pakistani peace processes. It does not always work, but it can, and it has.

Last but not least, a reality check: Bosnia is largely partitioned already. Even the West's new darling, Serb President Biljana Plavšić, wants to keep it that way—refusing to allow more than a handful of displaced Croats and Muslims to reset-



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tle in her Banja Luka region. Moreover, the Dayton accords legitimate two independent armies within Bosnia into the indefinite future. One of them, the Muslim-Croat Federation force, itself has two component parts that are only loosely tied together. The Dayton accords do not include even a paper plan for integrating Federation and Serb forces. Where is the precedent for a single stable country containing two or three separate and mutually hostile armies within it? One might point to China. But the concept of one China is a policy, not a political-military reality—and the policy works only because a wide strait, as well as the U.S. 7th Fleet from time to time, separates the two antagonists.

A Revised Peace Plan

Formal partition or no, the peace plan needs review. Most important, a revised plan should lower expectations about refugee resettlement. It should also give the Muslims—with nearly half of prewar Bosnia's population but only 30 percent of the territory under Dayton—additional land corridors that provide access to the sea (through southeastern Croatia) as well as to the Bihać pocket in northwestern Bosnia.

The Muslims, principal victims of the war and still the principal proponents of a multi-ethnic Bosnia, may not like this plan even with the new land corridors it would provide them. But there is little practical alternative—and we can sweeten the deal for them in other ways. For example, a new Muslim state should receive increased international aid to build housing for those displaced by war. The Muslims could also be offered more formal defense arrangements with the West, ultimately even NATO membership, provided they were prepared to forswear the use of force against neighbors and ensure civilian control of the military.

The Serbs and Croats would each achieve their primary goal—independence, and ultimately the chance to merge with Serbia or Croatia respectively—through this Dayton II approach. As the price to pay for self-determination, both the Serb entity and Croats now within Bosnia, as well as Croatia itself, would have to give up modest amounts of land to increase Muslim holdings to about 50 percent of Bosnia's present territory and make for a viable Muslim state. Most of the transferred land should probably come from the Serb entity, which represents about half of the country's land mass even though Serbs were only a third of Bosnia's pre-war population. (But the Brčko region in northern Bosnia, whose fate is

to be determined by international arbitrators in March, should be left within the Bosnian Serb entity to provide the Serbs with territorial cohesiveness.)

That would not be enough, though. If the Serbs and Croats wanted recognition, trade, and aid, they would have to satisfy several other conditions. Any further ethnic cleansing would, of course, be impermissible. That is an essential precondition to future peace even if Dayton's map is revised, because no map can form ethnically pure entities in a country where interethnic marriage involves perhaps 15 to 20 percent of the population (according to Mr. Holbrooke's figures). Transit and trading rights for foreigners would have to be assured. And Dayton's arms control accords would have to be fully respected.

What about the war criminals issue? We could continue essentially the current policy, pressuring extremists in the hope that they would eventually lose heart and surrender to

the Hague (as 10 prominent Croat suspects did in October). But it would be more realistic to allow each entity to establish judicial processes to deal with its own indicted citizens who are still at large. These processes could be based somewhat on the South African and Latin American models, by which simply holding people publicly accountable for their previous actions is deemed to have an important healing function for societies trying to recover from conflicts. In a partitioned Bosnia, monitors from the other two Bosnian ethnic groups and broader global community should be allowed to watch the proceedings as well. Individuals admitting to aggression against civilians would be banished from politics, though generally

spared long prison terms. Those claiming innocence but later found guilty would have to be imprisoned. Failure to follow these procedures would lead to economic sanctions and perhaps even a revocation of international recognition.

U.S. Troops Should Stay

Some argue that any need for outside troops in Bosnia after June should be handled by a European force, thus freeing U.S. troops—which bear major responsibility for the security of Persian Gulf oil and South Korea and global sea lanes—to focus on other missions.

At a military level, this argument is mostly right. NATO European forces are distressingly unable to help the United States handle security problems in places off the continent, yet are adequate to address threats that might arise in the relatively nearby Balkans.



But the issue has less to do with military capability than with political leadership. Who will lead on future Bosnia policy if not the United States? Germany is still haunted by World War II; France is not even a full member of NATO and has but a mediocre recent track record in handling humanitarian crises (witness Rwanda and Zaire); Russia can barely sustain a brigade as far away as Bosnia and, not being a member of NATO, cannot lead a NATO operation anyway. Britain might have the best mix of political savvy and military capability to be the guarantor of any new peace accord—but other European countries are unlikely to defer to its judgment when tough decisions have to be made about how to revise Dayton and when to use force. European security institutions like the WEU are probably composed of too many independent centers of decisionmaking to reach a new consensus on how to solve a problem like Bosnia just now. Dayton needs to be fixed in the same place it was made—the USA. And since peacemaking is as much about dedicated implementation as about signing a piece of paper, U.S. troops will be an essential part of the equation well beyond next June.

The good news is that the U.S. military is up to the job. Forces deployed in Bosnia, principally Army soldiers, may be a little rusty for warfighting when they complete peacekeeping assignments. But their leaders, like Generals Nash and Joulwan, the former commander of the 1st Armored Division and the former supreme allied commander in Europe respectively, have estimated that complete readiness can be restored in no more than 100 days. Since today's U.S. war plans envision sending divisions to any future war in successive phases over a period of several months, that delay would not represent a serious problem. The generals also argue that readiness actually improves in Bosnia for some military activities like engineering and logistics.

Although the U.S. armed forces are losing people to the civilian economy, Bosnia is not the chief reason. In fact, troops who deployed there recently reenlisted at a higher rate than those in the Army as a whole.

Even more to the point, the burden that Bosnia now places on the U.S. military is quite modest—for example, some 8,000 troops deployed in the Balkans out of an active-duty Army of 495,000. Even if again as many U.S. soldiers are backing up or supporting the troops in Bosnia, that amounts to only about 3 percent of the service's total strength. Including forces in Korea, and smaller deployments elsewhere, that means that the Army—which says it can maintain roughly one-fourth of its units on deployment if need be—now has just 10 percent of

its forces away from home base at a time. The Marines and Navy routinely manage an operational tempo three times as great. Moreover, the Army has by now adapted to its post-Cold War deployment pace and learned to spread the burden of these types of operations around to more units.

Actually, the biggest military problem with the Bosnia operation may be its effects on the Air Force, which has been losing pilots at a precipitous pace of late (largely because of the strength and attractive pay scales of the commercial airline business). But high operations tempo also contributes. Between the Southern Watch Operation in the Persian Gulf and maintaining the no-fly-zone in Iraq, the active-duty Air Force has been continually deploying some 15 percent of its force structure to relatively uninteresting and straining missions for several years. It may be time for European air forces to take over primary responsibility for the no-fly-zone in Bosnia, which at this point in the Bosnia operation is less central to the success of the mission than developments on the ground.

Partition Is Not Defeat

Renegotiating Dayton would admittedly amount to an admission of partial failure by the United States and international community as a whole. But if the United States and NATO help Bosnia achieve a workable peace, they will have succeeded at their core task.

A "Dayton II" plan might also help Biljana Plavšić in her ongoing struggle for power with Radovan Karadžić in Srpska by reducing the Serb paranoia about large-scale refugee resettlements and possible Muslim military attacks on which Karadžić's popularity depends.

The international community should not underestimate its ability to make this type of plan work. The substantial money it has set aside for Bosnian reconstruction is needed by all parties. The international community also has various types of security commitments to offer—a continued presence to keep stability as well as continued training for Muslim forces in the short term; possible NATO membership for the Muslim-dominated entity and perhaps the other two states down the road. It also has the stick of economic sanctions to apply again if need be, and the benefits of diplomatic recognition to confer on parties that comply with the new accords.

President Clinton's national security adviser was wrong when he said recently that to allow partition of Bosnia is to accept defeat. In Bosnia, some goals—notably, peace and economic recovery—are simply more achievable and more important than others. ■

Who will lead
on future Bosnia
policy if not the
United States?
Dayton needs
to be fixed in
the same place
it was made
—the USA.

A DEBATE ABOUT THE FUTURE OF BOSNIA

Avoiding Another Cyprus or Israel



A

BY SUSAN L. WOODWARD

favorite observation of commentators on Bosnia these days is that Bosnians have been able to live together in peace only under an external power—an empire, a dictator—that could prevent their ethnic hatreds and passions from exploding into internecine violence. But having a history of overlords is not the same as needing one.

*Susan L. Woodward, a senior fellow in the Brookings Foreign Policy Studies program, is the author of *Balkan Tragedy: Chaos and Dissolution after the Cold War* (Brookings, 1995).*

Fought over by Hungary, Rome, and Constantinople in the 10th to 13th centuries, Bosnia was conquered by the Ottomans in 1463. It was handed by the Great Powers to Austrian occupation in 1878 to keep a peasant uprising against landlord abuses from leading to union with Serbia, and then, in 1908, annexed by Austria. In 1939 Bosnia was conceded in large part by the royal Yugoslav government to a newly autonomous Croatian province, an occupation legalized in 1941 when Nazi Germany recognized an Independent State of Croatia. Bosnia gained its territorial integrity and independence within a federal Yugoslavia in 1945 because a buffer was needed to balance the power and finesse border disputes between the two largest republics—Croatia and Serbia. When that role was no longer necessary and Germany again recognized Croatian independence in December 1991, Bosnians had less than three months to create an independent state. Now politicians in Washington debate whether Bosnia should be reintegrated as a single, multiethnic country as called for in the Dayton accords or be partitioned into three states.

Imperial powers seem to have needed Bosnia far more than Bosnians needed them. Although the American-negotiated Dayton peace agreement and the NATO-led assistance in its

can be avoided, partition will produce a new wave of refugees even before the earlier refugees have returned in any substantial numbers and European interests in that regard are met. American leadership elsewhere and its reputation with its allies—particularly during a debate about NATO enlargement—cannot suffer a resumption of war in Bosnia if the United States pulls troops out prematurely.

Indeed, the partition argument looks less complicated than the Dayton process only because the partitionists have not yet proposed a plan for how they would partition. Bosnia is now divided into segregated communities of Bosniacs, Croats, and Serbs, but it is not partitioned. The interentity boundary line between the Bosniac-Croat Federation and Republika Srpska (the two constitutional entities of Dayton Bosnia) is not a stable *sovereign* border. The border between Croat and Bosniac communities, which Dayton negotiators refused to draw officially, divides towns, municipalities, and counties, includes numerous enclaves, and would require large movements of people if the two are also to separate into fully independent political units. None of the three communities controls the major strategic lines of communication necessary to independence.

O'Hanlon's proposal requires Washington and its allies to do as much *or more* to stabilize and pacify three separate states than we are now committed to do under Dayton for one Bosnia. Why then partition?

implementation are indisputably welcome, they do not appear to alter the real facts of Bosnians' history. The future of Bosnia has become an American project because the Clinton administration decided in 1995 that it was, after all, in the American interest—to preserve the NATO alliance, demonstrate U.S. commitment to European security, and reaffirm American leadership on moral principles. The interests of major powers—and their timetable—still hold sway.

A Washington Debate

The current debate about Bosnia, between those who believe the Dayton implementation process is working, but needs more time, and those who say that Bosnia has been partitioned and that the sooner we face the facts, the sooner we can leave, is a debate about one thing only: whether the United States should renew its military commitment to peace in Bosnia after next June. As even the partitionists are beginning to realize, however, either choice requires a longer stay in Bosnia. Although the partition option seems to some to provide a quicker exit than does the Dayton process, partition also leads to war unless it is carefully managed, with border skirmishes and irredentists policed for many years to come. Even if war

Negotiating this new “map” and its security guarantees will only return us to 1992 and restart the bickering, positioning, population transfers—and possibly war. Michael O'Hanlon's plan in the preceding pages requires the United States and its allies to do as much *or more* to stabilize and pacify three separate states than we are now committed to doing under the Dayton process for one Bosnia. Why then partition?

The fact is, it is too late for partition. What the major powers now need is a whole Bosnia and defense of the principle that no borders will be changed by force. Therefore, that is what will happen. As NATO Secretary General Javier Solana, President Clinton, Secretary of State Albright, and National Security Adviser Sandy Berger all made clear during October, there is no debate. The troops must remain for some while longer.

The Absent Debate

Meanwhile the real issue is not being debated. What are those troops to do? What is their mandate? What kind of troops should they be? That wise men and women can differ so fundamentally in their proposals for Bosnia is a measure of how unclear American objectives are. The “full-speed-ahead” Day-

tonists have simply found a mechanism to prevent debate, particularly debate with NATO allies and other interested states. The lesson of the international response to the Yugoslav crisis (without which there would have been no Bosnian war) is that disunity guarantees failure, coalition unity is the precondition of success. The Dayton accords have become the primary instrument of that unity.

But what American diplomats at the head of this united front are trying to do remains unclear. Since late last spring Secretary Albright's new foreign policy team for Bosnia has been increasingly assertive, including the use of force by SFOR (the NATO-led stabilization force) to get compliance with certain Dayton provisions: arresting indicted war criminals, helping create an alternative Bosnian-Serb power center to that of Radovan Karadžić in Pale, imposing rules on official media in Serb and Croat areas, taking over TV transmitters by force and jamming broadcasts from the air, protecting refugees and displaced persons trying to return to homes in strategic areas such as Brčko and its surrounding villages, now under direct American administration. The caution and impartiality of the military leadership in the first year of Dayton implementation have been thrown overboard.

In abandoning impartiality, however, they have also disturbed the delicate balance of the Dayton accords, leading Serbs and Croats to view American action as even more pro-Bosniac than they had thought and to think even more in terms of protecting their own national interests. For observers and allies currently standing behind the United States, these actions have raised new questions about the real goal of American policy. Is it to build a sovereign and viable Bosnia for all three communities or to fulfill prior commitments to some Bosniac leaders and their Islamic supporters by providing the bases for Muslim economic survival and self-defense, whatever the political outcome?

A Disappearing Exit Horizon

The shift in Bosnia policy has had results. A dozen-odd indicted war criminals now await trial at The Hague Tribunal, and the political fight in Republika Srpska appears to be weakening the Pale leadership. But in aiming at an early exit, it has in fact delayed that exit.

For example, the program to "train and equip" a Federation army of Bosnian Muslims and Bosnian Croats against a Bosnian Serb army was designed by American diplomats, over the loud and continuing opposition of its European allies, to facilitate an early exit of U.S. troops. Because the beneficiaries of this program are the one party with an interest in resuming the war—Bosniacs who would choose territorial conquest and population expulsion to expand their current 27 percent—if international forces leave now, the train and equip program has now become the primary reason that American troops must stay longer.

Equally, the shift from *process* in the first 18 months of Dayton's implementation to *compelling cooperation* has rejected the key lesson drawn by those working for peace on the ground in Bosnia in those first 18 months: that a "bottom-up," "civil

society," locally oriented, and reconciliatory approach is the only way to reintegrate the country. A "top-down" approach strengthens the role of national leaders and their ability to compel local compliance. While loudly criticizing "extreme nationalists" as the obstacle to Dayton, the new administrators are relying on them more. And punishing those who do not cooperate with the war crimes tribunal and the right of return to pre-war homes by withholding economic assistance runs counter to the broad consensus that an end to war in Bosnia requires economic revival—in all of its areas.

Whatever one's judgment about the responsibility of particular politicians in the war, it is generally recognized that

If troops are going to stay anyway, and they must, then why not use the time and money well?

Yugoslavia disintegrated because its political system overemphasized the national question, institutionalized rights of national self-determination, and lacked democracy—all characteristics shared by the constitution written for Bosnia at Dayton and the current methods of its implementation. The pro-Dayton team may actually be furthering the partition of Bosnia more than their pro-partition critics.

In fact, the one clear goal of this new assertiveness is to score successes before next June and prove to the U.S. Congress that its investment is paying returns and deserves support awhile longer. But the more assertive the implementation becomes, the more integral to the political process in Bosnia the international community becomes and the more the future of Bosnia depends on the actions of outsiders. Policy planners are also undermining the goal of American military planners, to shift the burden gradually back to Europe after June. The more Bosnia becomes an American project, the less able Washington is to hand it over to its European allies and NATO's new instrument for this purpose, the Combined Joint Task Force (CJTF).

The more pro-Bosniac American actions become and the fewer the assurances to Serbs and Croats that they will be secure in Bosnia, furthermore, the greater the risk that Serbs and Croats will secede and that allied unity will collapse over the creation of an independent Muslim state in Europe. These actions in turn make American policy dependent on what future the Bosniac leadership want to build—a subject now of heated internal debate within President Izetbegović's ruling party.

The Goal

If the troops are going to stay anyway, and they must, then why not use the time and money well? The separate project of

NATO enlargement now requires that troops stay until stability is restored. But what does stability mean? The partition version falters when supporters have to admit the likely costs, that no one is prepared to support a rump Bosnia in the way that the United States supports Israel. A containment school has thus reemerged, arguing for a milder Cyprus-like version of stability: a loose division within the country and a small, semi-permanent international presence to prevent violence. But Bosnia is not and cannot be Cyprus. It is not an island; it is three communities, not two; and the stability of the rest of the region depends in part on a resolution of Bosnia's political issues.

The demands of Bosnia's current leaders notwithstanding, the stability of Bosnia does not depend as much on nationalist political control over territory and government ministries as it does on the elements that make any country viable and legitimate. The disastrous state of its economy, the fact that war interrupted even the first stages of its transition from a socialist to a market economy, single-party rule in most of the country, the lack of independent police and judiciaries, and growing segregation of schools and religious control over curricula are far greater threats to Bosnian stability than borders.

those who held out throughout the war for a whole Bosnia, including many non-Muslims, and those refugees who have recently returned out of commitment to Bosnia. Neither will stay if there are no opportunities soon for work commensurate with their education, for travel, for occupational and status mobility.

As differently as the three Bosnian communities may view Bosnia's political fate, however, all share a more important commonality. In all the USIA opinion surveys, the first concern and priority of members of all three communities is employment. If the diplomats now working so tirelessly for one Bosnia could respect the current reasons for separation and redirect their efforts to the issues all three share, they might find an increasing number of allies for a common life in Bosnia. The beauty of the Dayton accords is that their numerous internal compromises and contradictions allow a whole host of interpretations and adjustments without abandoning the document. But there will be no Bosnia if the cooperation diplomats seek is with Dayton, rather than among Bosnians over their common interests and goals.

Finally, whether Bosnia remains whole or is partitioned, it

If the diplomats now working so tirelessly for one Bosnia could redirect their efforts to the issues all three communities share, they might find an increasing number of allies for a common life in Bosnia.

A Bosnia partitioned into three mini-states will be no closer to resolving these issues than one Bosnia. A preoccupation with border disputes and national security enables leaders to avoid these issues longer still.

It has been only two years since the guns fell silent after a brutal civil war of neighbor against neighbor. All groups remain so fearful for their physical safety that forcing reintegration now only offers myriad opportunities for violence and revenge. This explains in part why U.S. Information Agency opinion surveys show that Bosnian Croats and Bosnian Serbs do not want to live in a unitary state. But what if we interpreted these opinions not as evidence of hatred and desire for separation, but as a reflection of vulnerability and fear, of a belief that protection currently can come only from their own national group, and the conviction that a unitary state means a monoethnic state where Muslims will rule and where they, as numerical minorities, will have no protection and meager prospects?

If there is peace, time is on the side of the Bosniacs—in terms of demographic growth, international support, levels of education, and experience with urban living and foreign trade. But the core groups of their professional class, who have the skills to bring Bosnia into the post-communist world, are

cannot be stable if it has poor relations with its neighbors and if its neighbors too make little progress on democratization and economic reform. Opinion polls in Serbia and Croatia do not support partition, and both countries' struggle toward democratization would be even more difficult were they to incorporate parts of Bosnia. The international community insisted on the current Bosnian borders in 1992–94 to send the strongest possible signal to other groups in the area that borders are not up for change. Creating a smaller, Bosniac Bosnia will expand what is now a small conflict over the status of Muslims who are a majority in the Sandžak region of Serbia and Montenegro (who now call themselves Bosniacs, too) into a major irredentist explosion. The most immediate instance—the unresolved Albanian question crossing the borders of Serbia, Montenegro, Macedonia, and Albania, especially Kosovo nationalism—can easily destabilize the whole region, drowning all Bosnian successes with it, if it is not also resolved soon.

It may be too much to ask that the international operation now reverse a thousand years of Bosnian history and seek to structure an environment in which Bosnians can work out their fate or fates on their own. How we structure that environment, however, will decide how long we have to stay. ■



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